THE IMPACT OF CONSTITUTIONAL PHILOSOPHY ON ECONOMIC REGULATION

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ABSTRACT. This article addresses the intentions of the framers with regard to governmental participation in and control of business activity. This topic is particularly timely today as the U.S. defends its international position and considers the relevance of economic regulation enacted as long ago as the late 19th century. We review what worked in the past and consider whether the same solutions can work in the future. As America is governed by the Constitution, we argue that the framers would have chosen the preservation of our economic security and therefore would have disapproved of the current over-regulated business environment on pragmatic grounds.

Introduction

Interpretation of the U.S. Constitution constitutes an essential element in the functioning of the national government. Congress, the President and the federal judiciary are constantly required to reflect on what the framers intended and how the philosophy of a document drafted late in the 18th century influences decisions being considered in the 21st century. Congress considers the Constitutionality of new legislation; the President makes executive policy in the context of the separation of powers;

and the judiciary decides cases with an eye toward the intent of the framers. The Constitution apparently works fairly well; despite the passage of more than 200 years, there have been few recent revisions to the document, with only three amendments in the past half century, two of which were of national significance.[1]

The stiff language and succinct exposition of the Constitution make it extremely difficult to discern any philosophical perspective solely from a reading of that document. The framers undoubtedly understood that they were writing for the ages and carefully chose the words to include. As the result, modern commentators seeking philosophical insight inevitably refer to the eighty-five *Federalist Papers* (hereinafter "the *Federalist")*, written by Alexander Hamilton, James Madison and John Jay using the pseudonym Publius.[2] There is general acknowledgement that the *Federalist* had two purposes: to generate support for the new Constitution to replace the Articles of Confederation;[3] and to create a body of thought that would influence future interpretations and legislation.

Constitutional interpretation is essential to the functioning of American political, economic and social systems. The American legal system follows the Constitution in responding to the needs of a particular situation at a certain time in the nation's history, and not because of some philosophical position or ideal. The U.S. has survived innumerable challenges because Congress, the President and the judiciary generally have accepted what works, what is practical, and what is pragmatic.

A law is passed for various reasons, but pragmatism is often the driver. For example, the Civil Rights Act of 1964[4] was the response to intolerable restrictions on access to the polls levied against minorities, primarily African-Americans. Philosophical objections to unequal treatment of minorities did not matter until President Johnson counted the numbers of potential voters, assumed that many of them would be Democrats, and rammed the legislation through a reluctant Congress.

Philosophical Influences on the Constitution

Various commentators[5] have found elements of Locke, Hume, Montesquieu, Hobbes, Rousseau and other philosophers in the *Federalist*.[6] As one example, Publius (Madison) was clearly considering Hobbesian philosophy in the following comment in *Federalist* No.10:

> So strong is this propensity of mankind to fall into mutual animosities, that where no substantial occasion presents itself, the most frivolous and fanciful distinctions have been sufficient to kindle their unfriendly passions and excite their most violent conflicts.

Publius then examines conflicts that arise from the distribution and ownership of property. Of course, Publius does not follow the Hobbesian conclusion that monarchy is the best form of government, a clear illustration of the framers' ability to select arguments which support their position and ignore those that do not.

The influence of Montesquieu is also evident in the *Federalist*, especially regarding the issue of the separation of powers. However, Publius saw things differently than Montesquieu on other issues, e.g., the size of a republic necessary to safeguard against internal strife. The authors of the *Federalist* constructed more or less a 'patchwork quilt' of the views of thinkers like Hobbes, Hume, Montesquieu and others, using those parts (and ignoring those) that promoted their own pragmatic purposes. In fact, the authors of the *Federalist* did not have the time to offer (or debate the details of) a comprehensive, overarching moral theory, as they had to attend to the more immediate and more difficult task of trying to build a nation in violent and tumultuous times.[7]

While scholars have license to provide any reasonable interpretation they so desire, it must be remembered that the underlying theme in the *Federalist* was the promotion of the Constitution, the ratification of which was no certainty in the tumultuous atmosphere of the 1780s. Many Americans, burning with resentment of Great Britain’s cavalier treatment of its colonies, abhorred the idea of a strong central government. The new Constitution was necessitated precisely because of the weak position of a federal administration governed by the Articles of Confederation. Congress had been unable to adequately provide financial support for the American army during the Revolutionary War, or to develop economic policies that would allow the nation to counter the financial and trading power of the European powers.

Publius used the one medium available to the average citizen – the newspaper – to present its ideas and to generate support for the Constitution. To accomplish this, philosophical ideas on government, democracy and liberty were excerpted and used as needed to create arguments for public support. There was no central philosophy or controlling ethical theory explicit in the *Federalist*; rather, elements that worked in the struggle for ratification were used, while those that did not were excluded. As Morton White notes, the underlying philosophy was pragmatism not rationalism, empiricism, naturalism, idealism, objectivism or any other specific "ism".[8]

The Framers Were Pragmatists

There are examples of pragmatic analysis throughout the Constitution and the *Federalist* dealing with such diverse subjects as slavery, the separation of powers, and the concept of a strong central government as being necessary to maintain peaceful relations with other nations. To take the situation of slavery, the framers realized that the South would never agree to abolition or other resolution of the situation, and struggled to find an accommodation that would assure Northern and Southern support for ratification. There was no philosophical discussion of "the rights of man"[9] or political analysis of the long-range effect of slavery on the U.S.

Publius and the other framers did not worry about a future Civil War or pontificate on a possible peaceful resolution. Instead, the Constitution only addresses voting representation in Article I, section 2[10] and the "...Migration or Importation of such Persons as any of the States now existing shall think proper to admit" in Article I, section 9, with some discussion in *Federalist* Nos. 38 (Madison), 42 (Madison) and 54 (Madison or Hamilton).[11]

Other founding fathers were similarly able to think and act pragmatically. For example, Joseph J. Ellis in his sketches on the life of Thomas Jefferson shows this framer's ability to choose the necessary and not the idealistic course of action. Jefferson was a republican and strongly opposed to the nationalist policies of Washington, Hamilton and John Adams. Yet in commenting on his action on the Louisiana Purchase, Ellis states that "If the choice was between sustaining his strict interpretation of executive authority or losing half a continent, he chose the more pragmatic course ..."[12] And analyzing Jefferson's views on the judiciary: "...it was part of the genius of the constitutional settlement of 1788 to leave such controversial questions blurry and unresolved."[13]

Some four decades after the *Federalist,* American pragmatism was explained by Alexis de Tocqueville in *Democracy in America* in a comment on the common sense of the new democracy. He noted the skepticism of all claims for philosophical speculation except in its usefulness in achieving progress toward prosperity. Americans say that what is true is what is useful, and discredit the claims of one human being to rule over another on the basis of philosophical or spiritual excellence.

It should be noted that the one major philosophical school to develop in America was “pragmatism”, though this did not occur until the late 19th century in the work of Pierce, James, and Dewey. This school held that the truth of an idea is exemplified primarily by how it functions as a rule for action, rather than how it corresponds to any abstract set of relations. The emphasis on the practical over the speculative clearly has a long tradition in American intellectual history.

Pragmatism and the Business Environment

The tension between the political philosophies of the federalists and republicans continued into the 19th century and beyond, although the names of the parties have obviously changed. Democrats generally believe in a strong central government, while modern-day Republicans largely dispute the need for a powerful national government except for the requirements of national defense. Success in managing the process of legislation and administration constantly balances these divergent views while seeking pragmatic solutions to the problems of the moment.

Similarly, the sequence of economic laws did not follow a specific philosophical ideology other than the requirements of the times. Instead, the important laws on business activity grew from public and/or industry demand for relief and supervision. Economic regulation is generally considered to be laws and administrative procedures that are intended to protect competition and maximize consumer welfare.[14] Regulation is used to control the behavior of companies when a market economy may lead to results that are suboptimal to the public good. In certain situations, regulation is unquestionably useful, particularly when injury may occur to parties too weak and too scattered to protect themselves. Those parties may be persons, and we safeguard individuals through consumer protection and other laws.[15] Those parties may be inanimate but vital for our long-term existence, and we attempt protection through laws designed to avoid pollution and ecological damage.[16]

The first significant national laws that provided specific economic regulation appeared during the Civil War.[17] The Reconstruction period that followed began a period of Industrialization that was to continue until nearly the end of the 20th century. However, at the time of the passage of the first laws regulating business (other than banking), the U.S. was largely agrarian and preferred the republican model of limited government. Nearly two-thirds of the population lived in rural America and over 40% of all employment was still based on farming.[18] This economic regulation, which we discuss in the next section, was primarily a response to the demands of farmers and small businesses – those groups that historically rejected big government – who sought relief from the rates charged by railroads to carry their products to market.

Politicians and writers began debating the role of big business within a decade of the end of the Civil War, with particular focus on the economic and political power of large corporations. The economic environment allowed the development of corporate mechanisms that resulted in the restraint of trade,[19] which were considered to be artificial and unhealthy limitations on the forces of supply and demand in a competitive economy. Federal law requires these actions to involve interstate commerce;[20] most states also support competition in business through laws that mirror federal legislation.

Questioning the Role of Big Business

Angered by the "concentrated capital"[21] of big business, the third-party Populist political movement developed in America toward the end of the 19th century. Populist reformers felt that business domination of the political process through large contributions to friendly officeholders and effective lobbying in Congress and the state legislatures had reached the point that the practice had begun to undermine the concept of democracy. Demand for a legislative solution led to the passage of two landmark Congressional acts to control business:

- The Interstate Commerce Commission Act of 1887, which initially regulated rail transportation and was applied later to the trucking industry.[22]
- The Sherman Antitrust Act of 1890, which extended the concept of governmental regulation to any company engaged in interstate business.[23]

The essence of these laws was governmental protection of competition. In debating Senator Sherman's bill, Congress did not concern itself with economic efficiency or actual harm to consumers. Instead, the legislators responded to a widespread hostility toward business concentration and the resulting potential for governmental corruption and injury to individuals.[24]

The Interstate Commerce Commission (ICC) was created to ensure that shippers would have access to rail services at standard rates as established in a schedule of public tariffs. The ICC was empowered to assure reliability and used its Congressional mandate to control entry and exit, and to regulate rates so that reasonable but not excessive profits would be earned by the railroads. This structure continued even though the motor carrier industry became a viable competitor to rail after World War I, and in fact, the ICC later created a separate regulatory organization for this new transportation mode.[25] Following populist agitation for relief from the unfair practices of the trusts, Congress enacted the Sherman Act in 1890 and two additional laws in 1914 to assist in the implementation of antitrust policy.[26]

These legislative responses were a sort of lynch mob response to some very bad behavior by businessmen wearing black hats. Specific incidents included tripling or quadrupling the price of everything controlled by companies acting in collusion: the rail rates to farmers trying to get their produce to market; the cost of steel; even the price of sugar.[27] In the "high noon" days of the American frontier, the sheriff would have deputized a posse, rounded up and hung the villains, and cleaned up the town. Economic regulation attempted to placate the citizens of a frontier America, and got a real sheriff when President Theodore Roosevelt used the 1890 law to "pistol whip" big business.[28]

The next major economic disaster addressed by Congress was the Stock Market Crash of 1929 and the ensuing Great Depression. To avoid nationalizing private enterprise, a "solution" that was used in Europe in the 1930s, or other anti-capitalistic measures,[29] President Franklin Roosevelt (FDR) decided to follow the successes of his cousin Theodore and use free trade and regulation to "save" capitalism. Although it is not generally remembered today, FDR's Secretary of State Cordell

Hull was a strong supporter of free trade, and convinced the President to push the Reciprocal Trade Agreements Act of 1934[30] through Congress, reversing the high tariff barriers enacted in the Smoot-Hawley Act of 1930.[31]

Regulatory “alphabet soup” was the principal economic pillar of the first FDR Administration. Agencies such as the Agricultural Adjustment Administration (AAA), the National Recovery Administration (NRA), and the Civilian Conservation Corps (CCC) were among numerous attempts to create jobs and raise prices industry and farmers received for their production.[32] At the beginning of his first administration, FDR encountered the problem that the existing regulatory agencies were creatures of Congress and ostensibly independent. This does not imply that the President was restrained in his attempts to influence policy,[33] and the issue of Congressional versus Presidential control received a formal hearing in1935.

Who’s in Charge: the President or Congress?

The Supreme Court's opinion in Humphrey's Executor v. United States[34] decided that a regulatory agency was an "administrative body created by Congress to carry into effect legislative policies . . . . Such a body cannot in any proper sense be characterized as an arm or an eye of the executive."[35] FDR had attempted to remove a member of the Federal Trade Commission because of policy differences.[36] The problem of the control over regulatory agencies derives from the wording of the U.S. Constitution, specifically Article II, which states that "The executive Power shall be vested in a President of the United States of America" (the Vesting Clause) and that "[The President] shall take care that the laws be faithfully executed..." (the Take Care Clause). Proponents of the supremacy of the president use Article II to argue that the power of Congress to divest the President of control of the executive branch is limited. Therefore, it may be argued that independent regulatory agencies are unconstitutional to the extent that they exercise discretionary executive power and are not controlled by the President.

Critics note that the Constitution grants Congress the exclusive power to "make all Laws which shall be necessary and proper for carrying into Execution... all... Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof"; that the Constitution grants Congress the exclusive power "To make Rules for the Government and Regulation of the land and naval Forces"; that the Constitution specifically obligates the President to "take Care that the Laws be faithfully executed." Commentators generally refer to the power of Congress to pass laws and to the separation of powers as the actual intention of the Framers. The issue has never been absolutely resolved by the Supreme Court with regard to the regulatory agencies and has been a matter of debate for some time.[37] However, it is clear that departments of the executive branch, such as the Department of Justice and the Department of Transportation, are subject to Presidential control while the independent agencies are creatures of Congress but subject to Presidential influence.

This situation is relevant because most regulation is a creature of the Legislative rather than the Executive Branch. Once created by law, a regulatory agency is substantially independent, and generally focuses on its narrowly defined mission unless redirected by Congress. There have been few significant legislative changes to regulatory agencies; these include the termination of the ICC and the Civil Aeronautics Board (CAB), and the expansion of the duties of the Securities and Exchange Commission (SEC) to include corporate governance. However, it has usually been difficult to interest Congress in fixing regulatory problems; as an example, consider the efforts and years required to pass deregulation in the financial services industries.[38]

Regulatory changes through forceful Presidential leadership have occurred, usually in times of national emergencies. Action is demanded, and it is fortunate that most Presidents have taken the necessary steps to safeguard the Republic. During the crisis of the Great Depression, FDR responded with pressure on the existing regulatory agencies and the creation of new bodies. As Angel Moreno notes, he used such tactics as appointing and removing commissioners, jawboning, and public relations to coerce desired behaviors.[39]

The most prominent agency created during the early years of FDR's Administration was the Securities and Exchange Commission (SEC), which was conceived as the regulator to prevent stock market abuses through increased disclosure and required independent audits. James Landis, a prominent regulatory administrator, later wrote that the concept of the regulatory agency was necessary because of "... the inadequacy of a simple tripartite form of government [Congress, the President and the courts] to deal with modern problems."[40] The fourth branch of government – the administrative branch – used parts of each of the three other branches to use expert staff in the implementation of policy. As the result of the exigencies of the 1930s, the regulatory idea vested new authority in the existing ICC and Federal Trade Commission, and in new agencies: the Federal Power Commission, the SEC, the Federal Communications Commission, the CAB and the National Labor Relations Board. In sum, Congress avoided difficult political issues by assigning broad power to regulatory agencies that were able to use and extend their powers with relatively scant scrutiny from the courts.[41]

Our Present Hybrid (and Not Very Satisfactory) Regulatory System

Efforts at deregulation began in the 1970s. Several formerly regulated industries were allowed to fully compete on rates and service with the general result of lower prices to consumers. The opening of markets led to some disruptions, the leading example of which is probably the airline industry. The major national airlines were suddenly forced to compete with start-up carriers, and it became apparent that cost structures that were sustainable when competition was controlled by the decree of a federal agency (the CAB) could not be continued. As the result, Delta, Northwest Air, United and others filed for bankruptcy protection, while airlines like Southwest Airlines and JetBlue have flourished.

In spite of selected attempts to remove federal control, regulation remains pervasive and inevitably affects every business. Any listing of governmental regulation will depend on the bias and approach of the author. Some industries like banking and insurance are regulated in virtually all of their activities. We do this to protect bank depositors who have entrusted their savings to their banker, and to protect the community from a failure of a financial institution that might have a widespread catastrophic impact. Similarly, the failure of an insurance company would have a devastating effect on policyholders.

Other industries are subject to product safety requirements and advertising restrictions, but few other limitations. To say that a business is "regulated" does not reveal the extent of the regulation. While there are obviously various objectives in any regulatory scheme, the theme is the protection of competition to provide consumers with a range of choices to attain a desired mixture of price, quality, service and safety. Competition can also provide an incentive for businesses to pursue technological innovation and other efficiencies to maximize profits, regardless of the extent of the competition within a specific industry.

In a common law system,[42] courts function to decide the meaning of a statute passed by the legislature. While this sounds reasonable and perhaps represents a desirable goal of public policy, the regulation of business to prevent injury to other businesses or to competition is not as logical or as simple as the law suggests. In fact, the laws of economic regulation are among the least precise statutes ever passed by Congress, in that the language is often either too broad or too complex.

- Overly broad statutory language pervades the Sherman Act, including such vague terms as "competition," "unfair methods of competition," "conspiracy in restraint of trade," and "monopolize".
- Excessively complex statutory language includes the laws governing the securities industry (e.g., the Securities Acts of 1933 and 1934 and the Investment Company Act of 1940) and the Custom Service's regulations on importing (i.e., the published U.S. tariff schedule extends to several feet of printed volumes).

Why did Congress do this? Any legislature is essentially a political body responding to the wants and demands of constituents and pressure groups. When a public outcry for action occurs, Congress typically holds hearings, passes laws and hopes for the best. The Sherman Act and other antitrust laws and the recent law regarding corporate governance – the Sarbanes-Oxley Act of 2002[43] – clearly reflect public opinion at the time of passage but lack reasonableness test of the cost and benefits of implementation.

The situation is complicated by acceptance of monopolistic behavior when it is deemed to be in the public interest, another example of the pragmatic approach. From the nation's beginning, monopoly has been encouraged in certain situations through a variety of legal and economic barriers to market entry and competition.

● Legal barriers include requirements for charters, licenses and permit; patent protection for inventions and copyright protection for intellectual property; and government-sanctioned monopolies supposedly in the public interest, including public utilities (e.g., gas, electric and water) and restrictions on airwaves and other communication access.

● Economic barriers involve those situations where existing companies can largely exclude potential competitors, through economies of scale in manufacturing and/or distribution, product differentiation, discounts for quantity purchasing for large customers, and a variety of other devices, all completely legal.

The Market System and Regulation

The U.S. government has constructed an enormous web of business regulations functioning through at least a dozen agencies or departments. Some of these bureaucratic structures are absolutely necessary to allow the functioning of a market economy. For example, U.S. economic history prior to World War I is filled with the chaos of unregulated business cycles, which led to bank failures, corporate bankruptcies, and in 1907, a near collapse of the economic system. We could not function without the Federal Reserve to establish monetary policy; the Internal Revenue Service to collect taxes; and such departments as the U.S. Department of Transportation to construct highways, airports and similar infrastructure, and the State Department to negotiate treaties and agreements to expedite international trade.

Unfortunately, government bureaucracy is a kind of clumsy "invisible hand",[44] in that the judgment of market non-participants is often substituted for that of businessmen and their customers. Using a system of monetary exchange, an economic system transforms complex decision problems into drastically simplified ones. In the absence of a market system, someone has to face complex business problems, such as which goods and services to produce, how much of the gross domestic product should be consumed instead of saved, what sections of the country should specialize in what kinds of economic activity, and whether society should encourage farming or import agricultural commodities from abroad. In a market system responsive to individual consumer demands, no such questions have to be faced when the invisible hand decides.

Much of what occurs in the market system rests in the hands of businesspeople -- jobs, prices, production, growth, technology, the standard of living, and the economic security of everyone. Consequently, government officials cannot be indifferent to how well business performs its functions. Depression, inflation, or other economic distress can bring down a government.[45] A major function of public officials, therefore, is to see to it that businesspeople perform their tasks with a minimum of interference as long as they operate within established ethical and legal constraints.

What do business managers need as a condition for performing in a market system? Government has a responsibility to do whatever is necessary to assure sufficient profits to employ citizens and grow the economy in an orderly manner. For example, if business needs tax relief to induce investment, governments consider the request, acknowledging that the tax concessions may indeed be necessary. In these systems such concessions are often granted. Businesspeople do not appear simply as the representatives of a special interest, but as functionaries performing tasks that governments recognize as indispensable.

Any government representative who understands the requirements of his or her position and the responsibilities that market-oriented systems place on businesspeople will grant a hearing. The official does not have to be bribed, duped, or pressured to do so, nor does he have to be an uncritical admirer of businesspeople. He or she simply understands that public affairs in market-oriented systems are in the hands of government and business leaders that must collaborate toward the public good.

Conclusions

It is highly unlikely that Jefferson, Lincoln and the other great American leaders envisioned regulatory agencies as a fourth branch of government; there certainly is nothing in the Constitution or the *Federalist* that discusses the phenomenon. In fact, *Federalist* No. 47 specifically addresses the issue of the distribution of power and Constitutional attempts to limit the power of the various branches of government. Yet regulatory agencies are precisely what developed at times of national crises, including the supervision of banking during the Civil War, of antitrust and competitive practices during the populist movement of the late nineteenth century, of financial services and the airlines during the Depression, and of corporate governance during the financial scandals at the turn of the present century. Transitory situations that threaten the security of the country must be addressed, but actions that seemed necessary at an earlier time may no longer be appropriate to the needs of the present. And to their everlasting credit, the Founders were building for permanence and not for temporary emergencies.

Regulation assumes that free markets will not function to efficiently allocate factors of production, and that competition will be subverted to the disadvantage of consumers. There have been abundant instances of this outcome throughout the history of the U.S. However, each situation, with the exception of banking, has been of a relatively short duration, driven largely by an economic emergency that eventually was resolved. Presidents and Congressmen cannot wait for cycles to naturally end; if they do, people will be without jobs and may starve, there may be a significant loss of confidence in the future, the country could become ungovernable, and elected officials could be voted out of office. A businessman-engineer like Herbert Hoover waits for the inevitable cyclical upswing, and loses an election; a professional politician like Franklin Roosevelt sees a problem and knows that something must be done.

There are positive-sum regulations, such as those described earlier that affect consumers and the environment. However, there are also negative-sum regulations that adversely affect the ability of American companies to compete in the 21st century global economy. The economic regulations discussed in this article "protect" businesses from other businesses, with government officials substituting their judgment for that of the market in situations when such substitution is inappropriate and may result in the suboptimal allocation of the factors of production.

There are numerous areas of governmental intervention in business that interfere with its normal and ne- cessary activities, including antitrust, corporate governance and regulations that deal with specific industries.

Society cannot survive without laws that prevent the corrupt or criminal actions of businesspeople. We must protect the public from the current (and future) generations of Andrew Fastows, Martha Stewarts and Jack Abramoffs,[46] in the same way earlier generations investigated and prosecuted Charles Ponzi, Ivar Kreuger and Richard Whitney.[47] However, regulation must be pragmatic and reasonable, must reflect the changing requi- rements of the U.S., and should not assume that conditions of previous generations are in any respect similar to those of today.

Possible objections may be raised to this thesis from an ethical perspective. What is practical is not necessarily equal to what is moral, and many have frequently sacrificed what is right for what is expedient. However, economic regulation can be re- duced primarily because business, at least in the setting of A- merican capitalism, can be seen as essentially self-regulating. Any group endeavor requires a minimum of just behavior in order to properly function. As Plato said, there must be honor even among a gang of thieves, as they must act justly towards one another in order for their plan (albeit an immoral plan) to work smoothly.[48]

We could also look at the matter from a quasi-Hobbesian perspective, whereby the business environment is defined as a social contract. Although capitalism begins with the premise that people are motivated primarily out of self-interest, individual businesspeople are also rational enough to know that by entering into a social contract, their own self-interest is more effectively promoted than if they did not enter into the contract. We may even accept Hobbes' somewhat pessimistic account of human nature and suggest that if this social contract did not exist, the line between self-interest and pure selfishness would easily be blurred, and no one would trust anyone else. The system would thereby cease to function, ultimately benefiting no one.

The lesson learned from contemporary cases in business ethics is that the bad acts of a few can destroy confidence in an entire enterprise and threaten the integrity of the financial system. Business is basically a social contract whereby individuals relinquish their individual propensity to pursue selfish and ethically questionable behavior. In exchange, they are guaranteed a stable, secure system whereby smart and hardworking people may succeed if they play by the rules. And, as Hobbes believed, people enter into the social contract not so much out of altruistic motives, but because they are rational enough to know that this will best further their own interests in the long run. Some basic rules need to be in place, safeguarding against human rights violations and clear cases of fraud. But beyond this, we submit that minimal economic regulation is appropriate public policy.

REFERENCES

1. These were Amendment XXV [Presidential succession (1967)], Amendment XXVI [right to vote at age 18 (1971)], and Amendment XXVII [compensation of members of Congress (1992)].

2. The *Federalist Papers* are comprised of a series of articles written by Alexander Hamilton, James Madison, and John Jay, and are generally considered to be the definitive source for the ideas in the U.S. Constitution. The powers of the various branches of government are discussed in several papers: those of the President in Nos. 67, 69 - 70, and 76 - 77; those of the Senate in Nos. 62 – 65; and those of the House of Representatives in Nos. 52 - 53. The concept of a "temporary" situation in government did occur to the Founders, and that term appears in Nos. 10, 27, 34, 38, 55, 57-59, 63, 67, 68, 71-72, 78, 81, and 84–85. However, the references are to such issues as Presidential appointments, the number of Representatives in the House, and the terms of judges. Searches are available at www.yale.edu/lawweb/avalon/federal/fed.htm.

3. The *Federalist Papers* were published in issues of various New York newspapers (and reprinted in other locations) in the period October 1787 through August 1788, and compiled in single volumes beginning in 1788.

4. Public Law 88–352; codified at 42 U.S.C. 1971.

5. See, e.g., Morton White, *Philosophy, The Federalist, and The Constitution,* New York: Oxford University Press, 1987.

6. The framers were well educated and certainly acquainted with classical and contemporary philosophical theories; indeed, various sources note that Thomas Jefferson had one of the largest libraries in the U.S. at Monticello. However, specific philosophers were generally not referenced in the *Federalist Papers*, with only Montesquieu widely cited (in Nos. 9, 43, 47 and 78).

7. Strictly speaking, the authors of the *Federalist Papers* did not always ignore the elements of the theories they used that did not fit their purposes. For example, the *Federalist* contains some discussion about the disagreements

regarding Montesquieu's opinions regarding the size of republics; see *Federalist* No. 9. Overall, however, the method of Publius is to use bits and pieces of relevant theories to advance a practical agenda, rather than offer a sustained and comprehensive moral theory.

8. White, *op. cit.,* particularly Chapter 12.

9. Following the spirit of John Locke and Tom Paine.

10. <u>The language is interesting, in that the Constitution refers to "... the whole number of free persons, including those bound to service for a term of years, and excluding Indians not taxed, three fifths of all other Persons.</u>" The words "slave" and "slavery" are never used anywhere in the original document, and is only mentioned once in the entire Constitution, in the 13th Amendment. The 15th Amendment states: "The right of citizens of the United States to vote shall not be denied or abridged by the United States or by any State on account of race, color, or previous condition of servitude."

11. An interesting comment by James Madison in *Federalist* No. 38 is that: "The existing Congress ... can make treaties which they themselves have declared, and most of the States have recognized, to be the supreme law of the land. Is the importation of slaves permitted by the new Constitution for twenty years? By the old it is permitted forever." In other words, "something is better than nothing"!

12. *American Sphinx: The Character of Thomas Jefferson*, New York: Vintage Books, 1998, p. 249.

13. *Ibid*., p. 266.

14. This concept has been reiterated in numerous Supreme Court decisions; e.g., "...the unrestrained interaction of competitive forces will yield the best allocation of our economic resources ... the policy unequivocally laid down by the Act [the Sherman Act] is competition." N. Pac. Ry. Co. v. U.S., 356 U.S. 1, 4 (1958). See, also, U.S. v. Citizens & So. Nat'l Bank, 422 U.S. 86 (1975); Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979); and Nat'l Collegiate Athletic Ass'n. v. Bd. Of Regents of the Univ. of Okla., 468 U.S. 85, 107 (1984).

15. For a concise discussion, see *Consumer Protection Handbook*, New

York: American Bar Association, 2005.

16. The sources on environmental protection generally speak from a particular political view or are law books. Significant legislation includes the National Environmental Policy Act (1969), the Clean Air Act (1970), the Safe Drinking Water Act (1974), the Toxic Substances Control Act (1976), and the Clean Water Act (1977).

17. Banking legislation – the National Currency Act of 1863 and the National Bank Act of 1864 – established a system of government regulation for banks, and established the Office of the Comptroller of the Currency. The legislation was required to assist in the financing of the Civil War and to standardize a system of federally supervised national banks.

18. U.S. Dept. of Commerce, *Historical Statistics of the United States*, 1989. Population data is from series A57-72; employment data is from series D11-25.

19. *Restraint of trade* usually involves actions by a business or a group of businesses acting in collusion to restrict competition.

20. U.S. Constitution, Art. I, Sec. 8: "To regulate Commerce with foreign Nations, and among the several States" [the Commerce Clause].

21. This phrase is attributed to the economist Henry George, in *Progress and Poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth: The Remedy* (1879), Book III, Chapter 4, 9.

22. Interstate Commerce Act, ch. 104, 24 Stat. 379 (1887). originally codified as amended in scattered sections of 49 U.S.C.

23. See 26 Stat. 209. The Sherman Act is codified in Title 15 of the United States Code (U.S.C.).

24. For extracts from the Sherman Act debates, see Earl W. Kinter, ed., *Legislative History of the Federal Antitrust Laws and Related Statutes*, New York: Chelsea House Publishers, 1978.

25. The Motor Carrier Act of 1935 added bus and trucking companies to the jurisdiction of the Interstate Commerce Commission. Act of Aug. 9, 1935, ch.

498, 49 Stat. 453. Another impetus for this legislation was the decision of the Supreme Court in Buck v. Kuykendall, effectively eliminating state regulation of such transportation modes in interstate commerce; 267 U.S. 307, 315 (1925).

26. The Clayton Act of 1914 cites illegal anticompetitive behaviors, including prohibitions against exclusive sales contracts, local price cutting to freeze out competitors, rebates and interlocking corporate directorates; 38 Stat. 730, 15 U.S.C. § §12-27, 29 U.S.C. § § 52-53. The Federal Trade Commission Act of 1914 establishes the Federal Trade Commission (FTC) to investigate business practices; prohibits unfair methods of competition; 38 Stat. 731, 15 USC §1 et seq.

27. For a history of these situations, see William Letwin, *Law and Economic Policy in America: The Evolution of the Sherman Antitrust Act*, New York: Greenwood Press (reprint), 1981.

28. See, for example, Edmund Morris, *Theodore Rex,* New York: Random House, 2001, particularly the Prologue and Ch. 28.

29. The interested reader should consult Jeffry A. Frieden*, Global Capitalism: Its Fall and Rise in the Twentieth Century,* New York: W.W. Norton, 2006, Chapters 9 and 10, which discuss autarky and social democracy during the 1930s. ("Autarky" is the philosophy of economic self-sufficiency, and was practiced by the Third Reich in Germany and by Stalin's Soviet Union.)

30. Public Law 73-316, 48 Stat. 943 (1934). For a review of this development, see Kenneth W. Dam, "Cordell Hull, The Reciprocal Trade Agreements Act, And The WTO," 1 *NYU Journal of Law & Business* 709 (2005).

31. A protectionist Congress passed the Smoot-Hartley Tariff, Public Law 71-361, 46 Stat. 590 (1930), originally codified at 19 U.S.C. 1307. U.S. producers were shielded from importer competition, but other countries enacted retaliatory tariff, aggravating the worldwide depression. For further information, see Stephen D. Cohen, Joel R. Paul and Robert A. Blecker, *Fundamentals of U.S. Foreign Trade Policy: Economics, Politics, Laws and Issues* 32–33 (1996).

32. These and other agencies are described in an outstanding history of FDR's Administration by Arthur M. Schlesinger, Jr., *The Age of Roosevelt*,

Boston: Houghton Mifflin. See Volume 2, *The Coming of the New Deal* (1959), and Volume 3, *The Politics of Upheaval* (1960).

33. For a brief history of presidential attempts to influence the regulatory agencies, see Angel M. Moreno, "Presidential Coordination of the Independent Regulatory Process," 8 *Administrative Law Journal* 461, 481-486 (1994).

34. 295 U.S. 602 (1935).

35. Id., at 628. FDR was prevented from removing an FTC commissioner on the grounds of policy differences with the President as the agency was not a part of the executive department.

36. This conclusion has been widely criticized and largely ignored by various modern presidents in their attempts to "manage" of the goals of the regulators. See, e.g., Peter P. Swire, "Note: Incorporation of Independent Agencies into the Executive Branch," 94 *Yale Law Journal* 1766 (1985).

37. See, e.g., Harold H. Bruff, "Presidential Management of Agency Rulemaking," 57 *George Washington Law Review* 533 (1989).

38. Two examples include the McFadden Act of 1927 repealed by the Riegle-Neal Act of 1994, codified at 12 U.S.C. §1811 (prohibiting and then permitting interstate banking); and the Glass-Steagall Act of 1933 repealed by the Gramm-Leach-Bliley Act of 1999, codified at 12 U.S.C. §1843 (prohibiting and then permitting commercial and investment banking within the same institution). According to Robert Kuttner, "Financial companies spent $300 million over nearly 20 years to lobby Congress to get it to change the legislation [Glass-Steagall]." *Business Week*, November 15, 1999, at 28.

39. Moreno, *op. cit*, at 484.

40. James M. Landis, *The Administrative Process* (1938), 1. His Chapter 1 describes the regulatory approach conceived during the early FDR years. See also Daniel Yergin and Joseph Stanislaw, *The Commanding Heights* (1998), particularly Chapter 2.

41. The interested reader may wish to review Peter H. Aranson, Ernest Gellhorn and Glen O. Robinson, "A Theory of Legislative Delegation," 68 *Cornell Law Review* 1 (1982).

42. A “common law” system is primarily based on judicial interpretation of statutes enacted by a legislature, with precedents used to analyze a specific situation in a trial. However, courts can reinterpret statutes as social policy or other considerations changes; e.g., the Plessy v. Ferguson decision 163 U.S. 537 (1896), upholding separate but equal public facilities for different racial groups was overturned in Brown v. Board of Education of Topeka, 347 U.S. 483 (1954). The U.S. and Great Britain are the leading common law countries. The other major legal system in Western society is civil law, with statutes providing the core of the law as decided by legislatures. France and much of Latin America are civil law countries.

43. The Sarbanes-Oxley Act of 2002, 116 Stat 745 (2002), and codified in 18 U.S.C., mandated that U.S. publicly-traded corporations regularly assess their control and financial processes to ensure transparency and protect shareholder value. The law was enacted to restore investor confidence by requiring actions concerning financial reporting, conflicts of interest, corporate ethics and accounting oversight. Heavy fines for senior managers and their corporations, and even imprisonment, are available remedies, with the idea being to construct a strong incentive for business executive to obey the law.

44. To misuse Adam Smith’s famous phrase: "...[B]y directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by *an invisible hand* to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it." (Italics added). *The Wealth of Nations,* Book IV, Chapter II (1776).

45. A recent example in the U.S. was the defeat of Jimmy Carter by Ronald Reagan in the 1980 Presidential election. During the Carter Administration, short-term interest rates reached 20%. Another 20th century example was the defeat of Herbert Hoover by Franklin D. Roosevelt in the 1932 election.

46. Fastow pled guilty in 2004 to various charges relating to his responsibilities as treasurer of Enron and was sentenced to a prison term of six years in September 2006. Stewart was convicted on insider trading and served prison

time in 2004. Abramoff pled guilty in early 2006 to five criminal felony counts in federal court in a scheme to illegally bribe members of the U.S. Congress.

47. In the 1920s, Ponzi paid very high returns by using newly received funds to pay off earlier investors, effectively creating a pyramid scheme. Kreuger formed a trust to control all aspects of the production of matches in Sweden, and later throughout the world; speculation and fraudulent practices during the 1920s wrecked the trust and led to Kreuger's suicide. Whitney was indicated and pled guilty in the 1930s to the misuse of funds; the reform of the practices of the New York Stock Exchange resulted from his actions.

48. As reported by Plato in *The Republic*, Socrates attacks Thrasymachus on three fronts, the second of which uses the “honor among thieves” argument. Book 1, 351a.

REMITTANCES AND REAL INVESTMENT: AN APPRAISAL ON SOUTH AND SOUTH EAST ASIAN ECONOMIES

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ABSTRACT. This research analyzes the relationship between remittances and economic development in the context of South and South East Asian economies by using simultaneous equations model under the concept of panel data least-squares dummy variable regression model. Finally this paper comes out with an inverse relationship between remittances and real GDP in the perspective of Thailand, Sri Lanka, India and Indonesia.

1. Introduction

Due to an acceleration in labor mobility, remittance has been increasing considerably during the last three decades especially for developing countries (Buch, Kuckulenz and Manchec, 2002), and it is assumed to raise even more in the future. It is to be mentioned that annual remittances to developing countries have more than doubled between 1988 and 1999 (Gammeltoft, 2002). Remittance flows are the second-largest source of external funding for developing countries (Ratha, 2003), and it is to be the least volatile sources of foreign exchange earnings compared to private capital inflows that are vulnerable to economic swings. This is because the decisions by migrants to remit part of their income to their countries of origin are affected less by international financial market crises than the decisions of private investors and speculators (Ratha, 2003; Gammeltoft, 2003).

In economic literature, it is assumed that there is a positive relationship between remittances and economic development through accelerating private investment and consumption expenditures. Remittance generates positive effects on the economy if it is used for consumption expenditure; and remittance will contribute to output growth if it is spent on investment (Ratha, 2003; Stahl and Fred, 1986). However, a recent study has surprisingly found that remittance is negatively correlated to GDP growth and thus possibly a negative relationship with investment (Chami, Fullenkamp, and Jahjah, 2005). However, how can the results from the recent study be true?

This research intends to see whether there is a negative or a positive relationship between remittances and real GDP measured through consumption and investment in the context of South and South East Asian economies. The methodology employed in this research uses simultaneous equations model under the concept of panel data least-squares dummy variable regression model applying two-stage least squares technique. On the whole, this paper focuses on the interactive relationship between real GDP and remittances from the perspective of some selected South and Southeast Asian countries including Bangladesh, India, Pakistan, Sri Lanka, Thailand, Philippines, and Indonesia.

2. Methodology

On the basis of Keynesian model of income determination, this paper has considered only consumption, investment and government expenditure by excluding net export. It is assumed that theoretically remittance has a very negligible effect on the total value of net export. To examine the impact of remittance on economic development, consumption and investment channels have been included. In this regard, fixed effects model with dummy variable has been generated to formulate the consumption function. Thereafter, consumption function can be modeled in the following algebraic expression.

$$C_{it} = \gamma_1 + \gamma_2 D_{2it} + \gamma_3 D_{3it} + \gamma_4 D_{4it} + \gamma_5 D_{5it} + \gamma_6 D_{6it} + \gamma_7 D_{7it} + \delta R_{it} + \mu_{it}$$

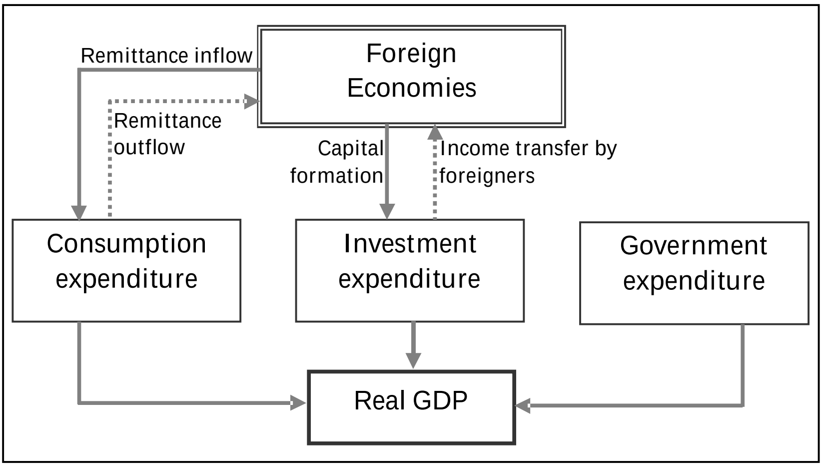
Where C is consumption expenditure; D is dummy variable; R is remittances; γ_1 is the intercept of base country; γ_i is the intercept of differential countries; and μ is error term. In this equation, intercept differ across individuals and each individual's intercept is time invariant. Therefore, the (fixed effect) intercepts are allowed to vary between countries by adding the dummy variable technique, which is termed as differential intercept dummies.

In case of real investment, as the definitive objective of this paper is to measure the effect of remittances in domestic capital formation, it is sensible to consider gross private capital formation as a proxy of real investment. Thereafter, the investment equation can be originated under fixed effects model approach.

$$I_{it} = \infty_1 + \infty_2 D_{2it} + \infty_3 D_{3it} + \infty_4 D_{4it} + \infty_5 D_{5it} + \infty_6 D_{6it} + \infty_7 D_{7it} + \boldsymbol{\beta} R_{it} + \boldsymbol{\mu}_{it}$$

Finally government expenditures are considered as an exogenous variable to avoid complexity in the model, as the determinants of government expenditures are hardly identified. Therefore, to examine the impact of remittance flows on economic development, the research has formulated a remittance model that can be visualized by tracing out flowchart 1.

Flowchart 1: Impact of remittances on real GDP



The simultaneous-equations model is the most appropriate econometric method for analyzing the above newly generated remittance model. Moreover, this paper will not apply the classical OLS method because the obtained estimators are not consistent. They do not converge to their true population values no matter how large the sample size is.

Consequently, as this remittance model is generated on the basis of simultaneous equations model, it is needed to apply the two-stage least squares technique developed independently by Theill (1953) and Basmann (1957). It is because the model is over identified according to the order condition of identifiability.

To sum up, the paper has applied the panel data regression model in order to examine the impact of remittances on the economic development across counties over time. It is to be noted that panel regression models are based on the same cross-sectional data over several time periods. This research is obtained pooled data on seven countries namely Bangladesh, India, Pakistan, Sri-Lanka, Thailand, Indonesia, and Philippines.

As selected countries contain their own specific characteristics; which are important elements towards the result of study, this paper has used *the fixed effects* (regression) *model* (FEM) or *Least-Squares Dummy Variable* (LSDV) *Regression Model*. FEM method has been chosen, because the intercepts in the regression model has made the difference among cross-sectional individuals due to the unique features of each selected countries.

3. Empirical results

This research is primarily based on secondary sources of data especially amalgamated from various issues of 'Key Indicators of Developing Asian and Pacific Countries' and Key Indicators (Volume XXXIII) published for the Asian Development Bank by Oxford University Press. Moreover, other relevant data are taken from the IMF publication International Financial Statistics (various issues). Nevertheless, it is to be mentioned that none of the sources of data is consistent and homogenous for a long time series data set because of differences in base year. However, finally it is visualized that data from 1987 to 2004 is homogeneous that is acceptable for the sake of maintaining balanced panel data set.

In this paper, fixed effects model under seven countries' pooled dataset has been analyzed. It is found that there are both positive and negative relationships between the remittances and consumption. Countries which are Thailand, Sri Lanka and Pakistan, they have negative relationships. That is, when net remittances increases, private consumption of the economy decreases. In contrast, Bangladesh, India, Philippines and Indonesia have been enjoying a positive impact of remittances towards consumption expenditures. In this regard, the value of R-square is not much different among all countries accept for Pakistan. In this regard, more than 90 percent of the variation in consumption is explained by the remittances in six countries.

There is only 77 percent of the variation in consumption is explained by the remittances in Pakistan.

Additionally graphical approach has been followed to detect autocorrelation in the model, and finally the problem of autocorrelation has been emerged. For the sake of correcting the autocorrelation problem, this research has applied the AR(1) and AR(2) method (Cochrane-Orcutt iterative procedure).

Similarly the investment equation of the remittance model can be analyzed in the same way. From the investment behavior, it is uncovered that Thailand, Sri Lanka, India and Indonesia have been facing negative impact of remittances on private capital formation while the others have a positive relationship. In this context, the values of R-square in all seven countries are quite high especially in the perspective of Bangladesh.

Hence, in the perspective of Thailand and Sri Lanka, both consumption and investment decrease due to the increase in net remittance flows. On the contrary, Bangladesh and Philippines are enjoying the positive effects of remittances on both private consumption and private capital formation. However the impact of remittances on consumption is stronger than that of investment. Hence, ultimately the growth rates of real GDP in Bangladesh and Philippines have increased due to an increase in net remittance flows. Hence, the policymakers of these economies should initiate some pragmatic measures that can induce remittance inflows for achieving potential level of real GDP.

Furthermore, India and Indonesia are experiencing a positive impact of the net remittance flows on private consumption, and a negative impact on gross private capital formation. More specifically, for Indian economy, if remittances increase by 1 per cent, consumption increases by 2.6 per cent and investment decreases by 2.6 per cent also. Hence the impact of remittances on the real GDP of Indian economy is neutral. It is because perhaps remittances increase consumption that will enhance imports.

However, surprisingly only Pakistan has been facing a negative effect of remittances on consumption, but a positive effect on investment. That is, remittance flows boost up gross private capital formation, whereas it diminishes private consumption of Pakistan economy. It proves that the marginal propensity to consume shrinks when remittances come to the economy of Pakistan.

4. Conclusion

It is admitted that the choice of an intellectual framework within which to examine the consequences of immigration is not a purely academic squabble. Normally the developing countries' policymakers facilitate their citizens to migrate outside the coun- try assuming that remittance will increase the growth rate of economic development. This research analyzes the relationship of remittances and economic development in the context of South and South East Asian economies. Theoretically remittances and real investment are positively related and these two combines a significant impact on economic growth. However, this logical postulation has been testified in this paper and come out with a reverse result in the perspective of Thailand, Sri Lanka, India and Indonesia. Conversely Bangladesh, Pakistan and Philippines have featured a positive impact of remittances on real investment. Hence, as a matter of fact, different governments should take different policies towards immigration for accelerating economic development.

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THE MONOTONICITY OF ASSET PRICES TOWARD CHANGES IN RISK*

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ABSTRACT. The goal of this paper is the examination of the conditions on preferences to guarantee the monotonicity of asset prices, when their returns change in the sense of first- and second-order stochastic dominances.

1. Introduction

Many studies have examined the effects of changes in risk on optimal risk-taking behavior. Rothschild and Stiglitz (1971) and Fishburn and Porter (1976) obtained two counterintuitive results in their seminal papers. Although risk averters improve their utilities for first- and second-order changes in risk, these stochastic dominances only lead to ambiguous comparative static results of optimal decisions for risk averters. In order to resolve these results, the development of this topic has followed two directions: restrictions on changes in risk and preferences.[1] An end of the research for the former direction is made by Gollier (1995) and that for the latter direction is made by Hadar and Seo (1990). It is natural to question how changes in risk affect asset prices. Gollier and Schlesinger (2002) gave the result for asset prices corresponding to the former direction. They determined the stochastic dominance that is an equivalent condition for asset prices to be monotone. This stochastic dominance cannot be compared with first- and second-order stochastic dominances. This means that asset prices do not necessarily have monotonicity when their returns change in first- and second-order stochastic dominance shifts. Hence the following question arises: What conditions on preferences must be imposed to guarantee monotone changes in asset prices for first- and second-order changes in risk? This paper answers to this question. To obtain the answer, we only add a natural condition from empirical and theoretical viewpoints to the conditions on preferences for optimal risk-taking behavior: No additional condition is imposed for first-order stochastic changes in risk and only prudence is required for second-order stochastic changes in risk.[2]

2. Stochastic Dominance

As an introduction, we give the definition and properties of first- and second-order stochastic dominances and denote a Cumulative Distribution Function (CDF) over a bounded support $[a,b]$ as $F(x) \equiv P(\tilde{x} \leq x)$.

Definition 2.1

- F_2 dominates F_1 in the sense of First-order Stochastic Dominance (FSD) if $F_2(x) \le F_1(x)$ holds for all $x \in [a,b]$. We denote this as $F_2 \ge_{FSD} F_1$;
- F_2 dominates F_1 in the sense of Second-order Stochastic Dominance (SSD) if $\int_a^x F_2(t)dt \le \int_a^x F_1(t)dt$ holds for all $x \in [a,b]$ and $\int_a^b F_2(t)dt = \int_a^b F_1(t)dt$. We denote this as $F_2 \ge_{SSD} F_1$.

The following properties are well known in the theory of stochastic dominance. Hence we give the following theorem without proofs. Interested readers can refer to Chapter 3 in Gollier (2001) for detailed discussions.

Theorem 2.1

- $F_2 \ge_{FSD} F_1$, if and only if $E[g(\tilde{x}_2)] \ge E[g(\tilde{x}_1)]$ for every increasing function g.
- $F_2 \ge_{SSD} F_1$, if and only if $E[g(\tilde{x}_2)] \ge E[g(\tilde{x}_1)]$ for every concave function g.

3. Comparative Statistics

3.1 Equilibrium Asset Price

Let us consider a static version of a Lucas (1978) economy. The economy is a two-date competitive and pure exchange economy with a representative investor. The representative investor has an expected utility representation with a strictly increasing, strictly concave and sufficiently smooth von Neumann-Morgenstern utility function (utility function) u, which means that all of required higher order derivatives are assumed to exist. The endowment of the investor is w units of a risk-free asset and one unit of a risky asset. The risk-free asset is the numeraire and the gross risk-free rate is normalized to one. The return on the risky asset is represented by a random variable $\tilde{x}$ with a CDF F defined over a bounded support $[a,b]$. The price of the risky asset is denoted as q.

Following Gollier and Schlesinger (2002), the equilibrium asset price is given as

$$q = \frac{E\left[\tilde{x}u'\left(z\left(\tilde{x}\right)\right)\right]}{E\left[u'\left(z\left(\tilde{x}\right)\right)\right]}, \quad (1)$$

where $z(x)$ is the final wealth in equilibrium defined by $z(x) \equiv w + x$.

3.2 First-Order Stochastic Dominance

We consider an economy $i \quad (=1,2)$ with a return on a risky asset $\tilde{x}_i$ distributed according to a CDF F_i, and suppose that F_2 dominates F_1 in the sense of FSD: $F_2 \geq_{FSD} F_1$. In this subsection, we examine what conditions on utility functions guarantee $q_1 \leq q_2$. First, we show the following lemma.

Lemma 3.1

Consider a random variable $\tilde{x}_i \quad (i = 1,2)$ with a CDF F_i, and suppose that

F_2 dominates F_1 in the sense of FSD: $F_2 \geq_{FSD} F_1$. If relative risk aversion defined by $R(x) = -u''(x)/u'(x)$ is less than unity, then $E\left[\tilde{x}_1 u'(z(\tilde{x}_1))\right] \leq$

$E\left[\tilde{x}_2 u'(z(\tilde{x}_2))\right]$.

Proof

Since the proof is similar to those of Lemma 1 in Hadar and Seo (1990) and Proposition 9 in Gollier (2001), we provide only an intuition of the proof. We find a condition on preference to guarantee that the function $xu'(x)$ is increasing in x.

We obtain the next proposition.

Proposition 3.1

Consider an economy i $(i=1,2)$ with a risky asset return $\tilde{x}_i$ distributed according to a CDF F_i, and suppose that F_2 dominates F_1 in the sense of FSD. If relative risk aversion is less than unity, then $q_1 \le q_2$.

Proof

By the above lemma, we have that

$$E\left[\tilde{x}_1 u'\left(z(\tilde{x}_1)\right)\right] \le E\left[\tilde{x}_2 u'\left(z(\tilde{x}_2)\right)\right]. \qquad (2)$$

Since $u'\left(z(x)\right)$ is a decreasing function of x, we have that

$$E\left[u'\left(z(\tilde{x}_1)\right)\right] \le E\left[u'\left(z(\tilde{x}_2)\right)\right]. \qquad (3)$$

Combining equations (1) and (2), we obtain

$$q_1 = \frac{E\left[\tilde{x}_1 u'\left(z(\tilde{x}_1)\right)\right]}{E\left[u'\left(z(\tilde{x}_1)\right)\right]} \le \frac{E\left[\tilde{x}_2 u'\left(z(\tilde{x}_2)\right)\right]}{E\left[u'\left(z(\tilde{x}_2)\right)\right]} = q_2 . \quad (4)$$

3.3 Second-Order Stochastic Dominance

We consider an economy i $(=1,2)$ with a return on a risky asset $\tilde{x}_i$ distributed according to a CDF F_i, and suppose that F_2 dominates F_1 in the sense of SSD: $F_2 \geq_{SSD} F_1$. In this subsection, we examine what conditions on utility functions guarantee $q_1 \leq q_2$. The analysis is parallel to the previous subsection.

Lemma 3.2

Consider a random variable $\tilde{x}_i \ (i = 1,2)$ with a CDF F_i and suppose that F_2 dominates F_2 in the sense of SSD:

$F_2 \geq_{SSD} F_1$. If

- absolute risk aversion defined by $A(x) \equiv -u''(x)/u'(x)$ is a decreasing function of x, and relative risk aversion is less then unity and increasing function of x; and/or
- relative prudence defined by $xP(x) \equiv -x\,u'''(x)/u''(x)$ is positive and less than two,

then $E\left[\tilde{x}_1 u'\left(z(\tilde{x}_1)\right)\right] \leq E\left[\tilde{x}_2 u'\left(z(\tilde{x}_2)\right)\right]$.

Proof

Since the proof is similar to those of Lemma 1 in Hadar and Seo (1990) and Proposition 9 in Gollier (2001), we provide only an intuition of the proof. We find a condition on preferences to guarantee that the function $xu'(x)$ is a concave function of x.

We obtain the next proposition.

Proposition 3.2

Consider an economy i $(i = 1, 2)$ with a risky asset return $\tilde{x}_i$ distributed according to a CDF F_i. Suppose that F_2 dominates F_1 in the sense of SSD and that the representative investor is prudent, i.e. $u''' \geq 0$.

If

- absolute risk aversion defined by $A(x) \equiv -u''(x)/u'(x)$ is a decreasing function of x, and relative risk aversion is less then unity and increasing function of x; and/or
- relative prudence defined by $xP(x) \equiv -x u'''(x)/u''(x)$ is positive and less than two,

then $q_1 \leq q_2$.

Proof

By the above lemma, we have that

$$E\left[\tilde{x}_1 u'\left(z(\tilde{x}_1)\right)\right] \leq E\left[\tilde{x}_2 u'\left(z(\tilde{x}_2)\right)\right]. \qquad (5)$$

Since $u'\left(z(x)\right)$ is a convex function of x,

$$E\left[u'\left(z(\tilde{x}_1)\right)\right] \leq E\left[u'\left(z(\tilde{x}_2)\right)\right]. \qquad (6)$$

Combining equations (5) and (6), we obtain

$$q_1 = \frac{E\left[\tilde{x}_1 u'\left(z\left(\tilde{x}_1\right)\right)\right]}{E\left[u'\left(z\left(\tilde{x}_1\right)\right)\right]} \leq \frac{E\left[\tilde{x}_2 u'\left(z\left(\tilde{x}_2\right)\right)\right]}{E\left[u'\left(z\left(\tilde{x}_2\right)\right)\right]} = q_2 . \quad (7)$$

4. Concluding Remarks

We examine the conditions on preferences to guarantee the monotonicity of asset prices, when their returns change in the sense of FSD and SSD. Our motivation stems from the counter-intuitive results obtained by Gollier and Schlesinger (2002): the FSD and SSD changes in risk only yield ambiguous comparative static results of asset prices. Whereas their approach to this result is the restrictions on changes in risk, our approach introduces the restrictions on preferences. Compared with the conditions on preferences to guarantee the unambiguous comparative static results of optimal risk-taking behavior, an additional condition on preferences for asset prices is prevalent from both empirical and theoretical viewpoints: risk aversion for the FSD changes in risk and prudence for the SSD changes in risk.[3]

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NOTES

[1] Gollier and Eeckhoudt (2000) provided a survey of this topic along these directions.

[2]Kimball (1990) showed that prudence households have positive precautionary savings. From empirical observations, households save money for future uncertainty. This means that prudence is justified from the descriptive viewpoints. See Kimball (1990) for further discussions.

[3]Since risk aversion is necessary for the existence of optimal portfolio and equilibrium, it is not explicitly appeared in conditions on preferences.

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ACCOUNTING MEASUREMENT AND FINANCIAL REPORTING

LUMINIȚA IONESCU

ABSTRACT. Accounting management typically refers to the firm's discretionary choices which affect the firm's reported performance by altering the accounting measurement process; in their model, Liang and Wen interpret investment deviations from the first-best as an example of real earnings management and accounting manipulation of y into w as accounting earnings management. Salvary notes that investments constitute the observable phenomena in financial accounting and recoverable cost, which is grounded in measurement and not prediction.

I investigate how the accounting measurement basis affects the capital market pricing of a firm's shares, which, in turn, affects the efficiency of the firm's investment decisions. Liang and Wen distinguish two broad bases for accounting measurements: input-based and output-based accounting; the structural difference in the two measurement bases leads to a systematic difference in the efficiency of the investment decisions (an output-based measure has a natural advantage in aligning investment incentives because of its comprehensiveness). The firm's objective is to maximize a weighted average of the life-time cash flows and the short-term share price; the market's inability to identify the sources of the first-period cash flow may induce a systematic short-term mispricing of firm value, from the firm's perspective. As the quality of accounting measures improves, one would expect less mispricing, which would lead to better investment decisions. Liang and Wen show that this conjecture is true for both the input- and output-based measures when the noise in these measures is high. That is, when accounting measures are highly imprecise, any improvement in precision will lead to more efficient investment decisions. Accounting management typically refers to the firm's discretionary choices which affect the firm's reported performance by altering the accounting measurement process; in their model, Liang and Wen interpret investment deviations from the first-best as an example of real earnings management and accounting manipulation of y into w as accounting earnings management. The output-based measures have a natural advantage in aligning the firm and social investment incentives through a dampening effect, which limits over- and under-investment tendencies (high levels of noise and accounting manipulation, which are typically associated with output-based measures, may make output-based accounting far from a perfect solution to all accounting problems). For an input-based measure, being less comprehensive makes small but positive accounting noise/manipulability desirable.[1]

Swanson and Miller develop a coherent theory of accounting measurement based on living systems theory (LST) and thus provide a fundamental framework for classifying the various accounting ideas and procedures into those that concern measurements of concrete economic processes and interpretations of those measurements. Contrary to most modern accounting theory, Swanson and Miller assert that the monetary scale is a ratio level measurement scale fully analogous to other measurement scales used by science, and reject the idea that the units of the scale are variable, showing that this general perception arises from the fallacy of confusing the objects being measured with the units of the measurement scale.[2] Accounting measurements of firms' investments are usually imprecise. Kanodia et al. study the economic consequences of such imprecision when it interacts with information asymmetry regarding an investment project's ex ante profitability, known only by the firm's managers; absent agency and risk-sharing considerations, Kanodia et al. find that some degree of accounting imprecision could actually be value enhancing.[3]

According to the argument for change, a real (constant) money measure of performance indicates that management is failing to maintain its physical stock of capital. As Salvary puts it, attempts have been made to alter financial accounting information in order to measure the impact of inflation on a business enterprise to assist the firm in making its investment decisions and the firm's shareholders in making their investment and consumption decisions.[4] Willett presents an axiomatic theory of accounting practice which describes accounting concepts in terms of sets; the theory provides a framework within which to understand the significance of accounting measurements for the probabilistic analysis of economic processes.[5] Salvary notes that investments constitute the observable phenomena in financial accounting and recoverable cost, which is grounded in measurement and not prediction; the measurement property, which is linked to investments and explicated by the capital budgeting model, provides the logical explanation of the apparent diverse rules in financial accounting and establishes a single attribute model. Although accounting information is highly informative, it is not a complete description/representation; financial accounting operates from the perspective of a conceptual framework and organizes perceptions into a closed system. Managerial accounting focuses on the effects of changing future conditions, which invariably will differ from those of the past under which the organization had performed. Financial reporting is much broader than financial accounting information; the essence of financial accounting is measurement (a measurement perspective for financial accounting standards is inescapable). In financial accounting, after the organization has made its decisions, the observer/measurer is not concerned with whether: (a) the investments are organized or disorganized; (b) the managers are fully informed or uninformed of the optimum path; or (c) the managers should be disinvesting instead of investing. Financial accounting measurement focuses on the productivity of money in use (the result of the measurement process is committed finance).[6]

Salvary claims that production and consumption provide the basis for investment; in this setting, recoverable cost becomes reified. Investment becomes crystallized in the form of recoverable cost as an independent structure (the firm is the personified function of investment, and recoverable cost is the reified function of invested resources).[7] The price level index is a function which maps one set of empirical observations into the set of real numbers satisfying a system of economically relevant conditions; this index is a derived measure for the transformation of observed prices into fictitious "constant price values". In a money economic system, the investment decision is indifferent to the physical quantities, but highly sensitive to the rate of return on nominal money invested.[8] Scott asserts that by assuming greater responsibility for incorporating fair values into the financial statements proper accountants are doing some of investors' work for them through increased use of valuations; if the securities market were fully efficient, this would not be necessary to the extent that value information was available in supplementary form or elsewhere.[9] Accounting's unique contribution to information processing is enabling managers and other social deciders to view the diverse matter-energy forms of a complex organization as a coherent whole on the attribute specific exchange value.[10]

Stein finds that the managers, facing stock market pressure, forsake good investments so as to boost current earnings, even though the market is efficient and is not fooled in equilibrium.[11] Using a contracting setting, Prendergast examines input-based and output-based measures and holds that input-based monitoring, coupled with a directed action, performs best in stable settings, while output-based monitoring is best in uncertain environments.[12] Lillis and Mundy seek to regenerate interest in a method that has been implemented in the past to promote productive field-based dialogue on issues related to complex constructs and their interrelationships, identify the range of questions suited to this method and how the method contributes significant insights to the management accounting literature, and articulate the design attributes of cross-sectional field studies by explicitly linking the rationale for these studies with the complexity of the phenomenon under study, sampling logic, instrument design, and data analysis protocols.[13]

Bhimani contends that there is mounting evidence that the deployment of digital technologies by enterprises affects not just their functioning in economic terms, but also mobilizes broader social, institutional, and organizational effects; knowledge about the influence of digital technologies on management accounting thinking process and practices is starting to emerge.[14] Bhimani's study[15] reflect established management accounting topics such as budgeting and responsibility accounting, contract theory analysis, contingency frameworks, performance measurement systems and strategic cost management which are considered within the perspective of changing concerns facing modern organizations and present day management thought.

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ENVIRONMENTAL MARKETING AND NATURE PROTECTION

AURELIAN A. BONDREA

ABSTRACT. Todd claims that environmentally aware individuals are already guided by their personal ethics; in trying to attract new consumers, environmentally minded businesses attach an aesthetic quality to environmental goods. According to Lozada, marketers should be encouraged to assess the cost of new laws and regulations, the cost of endless litigation, and the potential loss of competitive position(s) as integral and critical components of an ecological approach Schaefer says that sustainable development can be called the most significant and yet the most difficult problem that marketing face at the beginning of this millennium.

Todd holds that eco-marketers must carefully frame their environmental products in a way that appeals to consumers with environmental ethics and buyers who consider natural products as well as conventional items (eco-marketing constructs a complicated ethical identity for the green consumer). Todd claims that environmentally aware individuals are already guided by their personal ethics; in trying to attract new consumers, environmentally minded businesses attach an aesthetic quality to environmental goods. Todd analyzes the promotional materials of three companies that advertise their environmental consciousness: Burt's Bee's Inc., Tom's of Maine, Inc., and The Body Shop Inc.;

responding to an increasing online shopping market, these companies make their promotional and marketing materials available online, and these web-based materials replicate their printed catalogs and indoor advertisements. Todd remarks that as part of selling products to consumers based on a set of ideological values, these companies employ two specific discursive strategies to sell their products (they create enhanced notions of beauty by emphasizing the performance of their natural products, and thus infuse green consumerism with a unique environmental aesthetic.[1]

Aragón-Correa describes a revision of the model of consumer behaviour with respect to the environment and its connection with the ecological concern of individuals (a structural equation model is proposed and is verified empirically with respect to a hypothetical recycling project in the Spanish market).[2] Tisma et al. contend that ecological approach has become a *weltanschauung* in all walks of life, so that ecological issues have come into the focus of marketing interests with an increasing tendency in years to come. Tisma et al. define the framework from which the ecological marketing has emerged, and explain its notion and concept. Tisma et al. show what are the differences between ecological and classical marketing (especially concerning different approaches with respect to fundamental functions of marketing).[3]

Lozada remarks that since the early 1990s, a renewed interest of the marketplace on ecological concerns surfaced: not only is the relationship between humans, organizations, and the natural environment being redefined, but the implications thereof are being reinterpreted; the goals of economic and social development must be defined in terms of sustainability (development is taken to mean a progressive transformation of economy and society which is sustainable in a physical sense). "Green marketing forwards the notion that companies should be concerned with what happens to a product during and after its useful life. Companies may manifest this concern through experimentation with ways to reassess and redesign the product life stages. Life cycle reassessment focuses on environmental considerations in product development and design, including energy and material inputs and outputs in production, consumption, and disposal of products. We would then manage the life stages of a product in an environment friendly and eco-efficient manner. *Eco-efficiency* refers to the proper timing for the use or consumption of natural (and oftentimes scarce) resources so that nature is afforded an opportunity to renew itself."[4] According to Lozada, marketers should be encouraged to assess the cost of new laws and regulations, the cost of endless litigation, and the potential loss of competitive position(s) as integral and critical components of an ecological approach; in developing value-added on ecological bases, organizational leaders would have to establish a level of environmental commitment that is most suitable and feasible given the conditions that the organization faces. "Pressure from various stakeholders (government, special interest groups, consumers) is placed on businesses, which in turn keeps them under constant and unrelenting watch in their daily operations. A direct result can be seen in the stricter regulations imposed by federal and local governments. Additionally, consumers are also becoming more outspoken regarding their needs for environmentally friendly products, even though questions remain on their willingness to pay a higher premium for such products."[5]

Lozada argues that firms should thoroughly consider the implications of a potential loss of corporate and product credibility due to perceptions of inaction or forced compliance. Lozada contends that the life stages of products would include the following: (i) development stage (traditionally characterized as the acquisition of raw materials, component parts, and subassemblies); (ii) production stage (manufacturing companies are encouraged to reduce emissions, toxicity, and waste, and to conserve water and energy); (iii) consumption/usage stage (minimization of packaging, conservation of energy, and minimization of waste from product maintenance and service are strongly urged); (iv) the final stage of a product is its disposal (green marketing introduces the concepts of reuse and recyclability, in addition to the concept of waste reduction). Lozada notes that a green marketing approach in the product area promotes the integration of environmental issues into all aspects of the corporation's activities, from strategy formulation, planning, construction through production and into dealings with consumers. "Regulatory pressures may account for some of the most creative ideas that have been brought to market. For example, batteries of all kinds contain hazardous heavy metals such as silver, mercury, nickel, cadmium and lead that can threaten underground water supplies. The potential for increased regulatory pressures always faces these manufacturers, including legal requirements to reformulate products or setting up collection programs for the 'dead' product. In 1990, Eveready reformulated their batteries to reduce mercury content, meeting regulatory standards two years ahead of schedule and stealing an edge on competitors through trade advertising."[6]

Schaefer says that sustainable development can be called the most significant and yet the most difficult problem that marketing face at the beginning of this millennium. "Conventional marketing practice, what might be called 'brown' marketing, has been criticized for its lack of ecological sustainability. The key points of criticism are that it promotes excessive consumption and materialism, and that product design is often environmentally wasteful due to short durability of products, products not being designed for recycling and excessive material use. No part of the marketing chain is without criticism. Excessive packaging, production of marketing materials and the transportation of finished goods often over long distances are all criticized as being wasteful of resource. In this sense, marketing and environmental sustainability are often seen as directly opposed and the very notion of sustainable marketing as an oxymoron."[7] Schaefer states that it is instructive to take a look at marketing as a subsystem of the economic system: the theory of living systems can be used fruitfully to conceptualise social systems, particularly with respect to ecological sustainability. Schaefer remarks that processes include communication and material processes: the marketing system communications would not just include “marketing communications” but also the other elements of the marketing mix, consumer behaviour, and communications by governments and NGOs. “Material artifacts are often, perhaps even predominantly produced in an ecologically and socially unsustainable way and current green marketing practices do not seem to change this unsustainable production significantly. There are many arguments that the technologies for radically more efficient materials use are being developed and perhaps even on the brink of commercial viability. [...] A sustainable marketing system would have to be flexible, decentralized, and open to learning from environmental cues, such as emerging evidence of impending raw material shortages, observable environmental changes with respect to forest cover, soil fertility, air and water quality and less readily observable global environmental changes, such as climate change. Experiments to deal with these environmental changes would emerge in various forms and at various places and multiple feedback loops would help to identify viable solutions and spread them.”[8]

Schaefer maintains that in each period of time there has to be someone who is prepared to borrow money to invest, so that income for all companies rises in such a way that they can pay their interest and make a profit; if the capitalist system is built on growth, serious implications for the question of ecological sustainability arise. Schaefer charts the development of green marketing and its limitations, and shows what the implications of living systems theory for a sustainable marketing system would be. “Flexibility and openness to environmental triggers and an ability to learn through networks of information and practice so that novel solutions can emerge seem crucial for a sustainable living system. The marketing systems would seem to show some characteristics of an open, living system, in that would seem to have a fairly open and flexible form, at least in principle, with numerous feedback loops, that should make it fairly amenable to learning and emergence of new solutions.”[9]

Wollenburg underlines the complementary multiple objectives of conserving forests, enhancing livelihoods and improving social conditions, which must be met for such efforts to be sustainable.[10]

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FINANCIAL INCLUSION *VERSUS* FINANCIAL EXCLUSION

ELENA-DOINA DASCĂLU

ABSTRACT. McKillop et al. remark that credit unions, which embrace an income mix of members, may result in more sustainable credit unions in the longer term. Byrne et al. find that a significant number of people who borrow from money-lenders also borrow from mainstream sources of credit, and explain why new policy is needed which must not only focus on access to financial services but equally on financial education and regulation. Collard reviews the progress that has been made in promoting financial inclusion in three areas of financial services provision (banking, consumer credit and insurance) and the challenges that remain; transactional banking services are the bedrock of financial inclusion.

McKillop et al. provide a review of recent government policy towards credit unions, credit union activities are then matched to ward-level deprivation measures to assess the extent to which credit unions operate in areas of most high deprivation, and examine whether there is a link between credit union performance and the level of area deprivation. “We recommend that policies designed to assist credit unions should be ‘targeted’ to particular areas of need, but not used to fund core business activities or as a substitute for self-reliance on sufficient revenue generated by credit unions themselves. Policies that encourage credit union development based on a cross-section of the population, including affluent sections of society, offer the best long-term model of credit union development."[1] McKillop et al. remark that credit unions, which embrace an income mix of members, may result in more sustainable credit unions in the longer term; credit unions generally need between five and ten years to become adequately capitalized and sustainable (to minimize the distortion that may result from the inclusion of data on young credit unions only credit unions that existed continuously over the period 1995 to 2001 are included). McKillop et al. contend that grant providers to credit unions should be aware that there is a risk that grants and other forms of subvention may undermine the self-help principle on which credit unions are based; government and trade association policies that encourage credit union development based on a cross-section of the population, including affluent sections of society, offers a viable long term model of credit union development; credit union financial data, submitted under the regulatory regime of the FSA, should be in the public domain to facilitate independent scrutiny of the sector and to enable researchers to determine the characteristics of those credit unions which are long term sustainable and best serve the needs of their members. "The analysis of credit union location and performance provided a number of interesting insights. Credit unions in NI are strong performers irrespective of whether they are based in areas of high, medium or low deprivation. This suggests that credit unions in NI have been accepted by a broad income mix of members from within their common bond. This appeal of the credit union movement to all segments of society in NI is emphasized by the fact that from 1997 to 2000, membership and asset growth has in fact been greatest for credit unions located in areas of least deprivation."[2]

Byrne et al. find that a significant number of people who borrow from money-lenders also borrow from mainstream sources of credit (the borrower and money-lender relationship is complex and is not centred on access alone), and explain why new policy is needed which must not only focus on access to financial services but equally on financial education and regulation. Byrne et al. carry out a survey to estimate the extent of money-lending and to establish the profile of the typical money-lender client in one rural town and one city suburb community in the Munster region of Ireland. "Money-lenders are often considered 'heavy-handed characters'; however their customers do not view them in this way. The majority of money-lender borrowers have other sources of credit and are using the money-lender because of convenience, tradition or for certain purposes other than because they are financially excluded. However, this is not the case for all. While money-lenders may strive to develop a good relationship with their customers, the agents who are dependent on commissions will be under pressure to collect as much as possible every week and may have a tendency to encourage customers to continuously borrow and possibly to 'impulse-borrow'."[3] Byrne et al. note that the key witness from MABS and the credit union highlighted the role of tradition in the decision to borrow from a money-lender; the view of the credit union and MABS personnel is that people do not view money-lenders as being ‘a problem’ or as a ‘source of hardship’; in terms of access, MABS highlight that people who have broken their connection with money-lenders often renew that relationship at times of emergency when they need money very quickly. According to Byrne et al., there are a number of possible areas of focus on financial education: (i) to support further research on financial capability; (ii) to expand financial education programmes in schools (as habits are formed at a young age, teaching our young about wise use of money may have beneficial impacts as they move into adulthood); (iii) to use public information campaigns to increase financial capability in wider society; (iv) to support an additional community education role for money and budgeting advice services; (v) to strengthen the financial education role of credit unions (at present their financial education is primarily provided through the credit controllers when a person is already in debt). “While recognizing that money-lenders are not ‘dark and nasty’ characters and that they often provide a good, convenient and sometimes necessary service, they are not adding to the long-term financial security or autonomy of their customers. They may well be ensuring, albeit not deliberately, that many of their customers remain in long-term poverty. Thus, monitoring and curtailing the worst excesses of money-lending is in the interests of public policy.”[4]

Collard reviews the progress that has been made in promoting financial inclusion in three areas of financial services provision (banking, consumer credit and insurance) and the challenges that remain; transactional banking services are the bedrock of financial inclusion. “A number of factors have kept people outside the banking system: many people on low incomes fail the credit scoring used to screen potential customers for a conventional current account; current accounts do not enable people on low incomes to keep adequate control over their finances, as they cannot be certain how quickly transactions will be processed on their accounts. As a consequence people with little leeway in their budgets tend to go into overdraft for small sums of money over short periods of time, but incur standard fees for doing so; many people on low incomes find it difficult to provide the types of proof of identity required by banks and building societies to meet the money-laundering regulations; the payment of social security benefits and state pensions by order book or girocheque reinforced people’s propensity not to use a current account.”[5] Collard maintains that the incidence of failed direct debits is generally higher among low-income account-holders because it can be difficult for them to assess if they have sufficient income in their account to cover the payment; despite the expansion of the UK consumer credit market, access to high-street credit is still severely constrained for people on low and insecure incomes. “Arguably the greatest impact on widening access to affordable credit would come from a reduction in the charges levied by commercial lenders. The Competition Commission has been considering whether lending practices in the home credit sector impede competition and lead to excessively high charges. Recent changes to consumer credit legislation, encompassed in the Consumer Credit Act 2006, are intended to contain the costs of commercial credit, by broadening the existing (and ineffective) extortionate credit provisions to encompass unfair terms and practices as well as the cost of credit."[6]

Carbo et al. remark that financial exclusion has emerged as a concern for policy-makers on both sides of the Atlantic in recent years; the widespread process of financial services liberalization and the subsequent intensification of bank competition may explain why financial exclusion has become more visible over the past decade or so; financial exclusion refers broadly to the inability of some societal groups to access the financial system. "Although financial exclusion is not a new problem, its consequences are becoming more serious. A lack of banking facilities, for example, is especially problematic in an environment where a growing volume of payments are made via a bank account. [...] Those without access to mainstream credit facilities may also face serious practical difficulties – credit needs cover both short-term facilities (to smooth peaks and troughs in household budgets) and different kinds of loans to buy larger items. As a result, the financially excluded often borrow from 'non-status lenders' who charge high prices. Since these loans are often secured on the borrower's property, the consequences of non-repayment are especially serious."[7] According to Carbo et al., financial exclusion from basic bank transaction accounts is often a good broad indicator of financial exclusion in a country; financial exclusion appears to be exacerbated by the forces and 'strategic mindset' of financial services firms that are incentivized to maximize returns in an increasingly competitive and deregulating environment; in many European countries, the historic and institutional apparatus have emphasized more strongly 'public models' and social responsibility. "The US system is in many respects the 'pacemaker' in the development of financial services. On the one hand, financial services are produced more efficiently than in many other countries and are particularly responsive to the 'shareholder model', the free market. On the other hand, this kind of model by itself appears to have a negative impact on financial exclusion. Both the US and UK financial sectors are probably the most deregulated and market-orientated in the world. In both countries, significant policy responses also characterize government action."[8]

Carbo et al. outline the difference in approach to financial exclusion in European countries; the offer of basic bank accounts lies at the heart of many European countries' efforts to increase financial inclusion; there are clearly different "models" for responding to financial exclusion in Europe, and in all of these banks play an important function; public policy towards tackling financial exclusion in Europe has followed a piecemeal/*ad hoc* approach. "Within the framework of market liberalization, the 'general economic interest missions' are the means by which a balance nay be struck between competition and protecting more vulnerable consumers. Nevertheless, the position of the EC remains imprecise, undeveloped and not altogether transparent on these general interest missions in the context of financial exclusion and areas related to it (like the provision of basic banking services and the development of regional financial infrastructure)."[9]

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FINANCIAL INTEGRATION AND MONETARY POLICY OPERATING PROCEDURES

DAN-RADU RUŞANU

ABSTRACT. Andersen and Moreno claim that financial integration has been evident in frequently high correlations between asset yields or prices. Mohanty and Scatigna discuss the choice of exchange rate regime in the context of greater global financial integration, review recent movements of exchange rates. Hawkins discusses the influence of globalization on operating procedures. Mihaljek discusses two complications for domestic monetary policy stemming from greater international integration of the emerging market economies.

Andersen and Moreno claim that financial integration has been evident in frequently high correlations between asset yields or prices (particularly for certain asset classes such as high-yield corporate bonds and sovereign bonds and equities in developed and emerging markets). Andersen and Moreno write that (i) countries have made efforts to reduce their vulnerability to external shocks (since concerns about debt sustainability have played a role, countries have sought to limit domestic and external debt); (ii) international financial integration has encouraged central banks to shift towards market-based instruments that enhance their ability to respond to shocks; (iii) there has been a gradual deepening of and improved resilience in domestic financial markets in emerging economies; (iv) international investors are now better able to differentiate between countries, thus reducing the risk of contagion. “Notwithstanding these favourable developments, which might help to attract foreign investors and stimulate domestic investment, financial integration may imply that emerging financial markets are more vulnerable to certain types of shocks, and that it may be difficult in some instances to find suitable instruments to manage these shocks. For example, consider how foreign exchange markets (the main conduit for the transactions that occur as a result of growing financial integration) have evolved and what this might imply for economic and financial stability. Greater financial integration may amplify volatility in foreign exchange markets, and this effect may be heightened by the introduction of modern risk management techniques.”[1] Andersen and Moreno contend that the broader question of how the exchange rate regime influences average growth and inflation in a financially integrated world remains to be settled; independently of their exchange rate regime, financial integration can make countries vulnerable to external shocks that reduce growth and consumption smoothing benefits. “Global financial integration has substantially increased in recent decades. Initially, it manifested itself in growing capital flows between developed countries. In response to the removal of capital controls, financial innovation and technological progress, financial integration has subsequently spread to emerging market countries. [...] Many argue that increased integration with global financial markets has been key in imposing market discipline on policymakers, and has helped to improve the quality of macroeconomic management. In addition, financial integration in emerging market countries has been driven by the belief that it would increase growth and reduce volatility."[2]

Mohanty and Scatigna discuss the choice of exchange rate regime in the context of greater global financial integration, review recent movements of exchange rates, address the reasons why the authorities might wish to resist such movements, explore the implications for monetary policy, discuss the role of foreign exchange intervention, and focus on capital account policies. Mohanty and Scatigna note that as the Mexican and Asian crises in the second half of the 1990s demonstrated, a (semi-)fixed exchange rate often led to significant overvaluation of the real exchange rate; with growing trade openness and the increased incidence of external shocks, the role of the exchange rate as an automatic stabilizer has become better appreciated. "When governments have a large outstanding foreign currency debt or debt indexed to the exchange rate, large currency depreciations can raise questions about fiscal sustainability, increasing risk premia and sovereign spreads. Many participants in the meeting argued that intervention could not be avoided in presence of significant currency mismatches. For instance, liability dollarisation played a special role in the recent Brazilian and Turkish financial crises. Similarly, with three quarters of debt being dominated in dollars, devaluation had strong contractionary implications for Peru's economy. In some countries (e.g., Poland) already weak balance sheets of firms aggravated problems of currency depreciation, requiring central bank intervention."[3] Mohanty and Scatigna maintain that, in many countries, the central bank's foreign exchange operations may be large in relation to the total foreign exchange market turnover or interbank trading; foreign exchange interventions are not always sterilized in emerging economies; because of their great importance and regulatory powers, central banks in emerging economies may possess information advantages over the dealers, which they may use to enhance the effectiveness of their intervention. "As reserves rise, their domestic implications tend to attract more attention. Such implications are likely to be felt in pressures for sterilizing reserve purchases as well as in macroeconomic variables. In Asia, reserves have been growing at a particularly rapid rate during the past three years, with reserves now accounting for many times the monetary base. To the extent that large increases in foreign reserves are unsterilised they could lead to an undesirable expansion in the monetary base and a loss of monetary control. Even though nominal appreciation has been successfully resisted, the real exchange rate would then eventually appreciate as growing capital inflows and higher monetary growth raise aggregate demand and inflation."[4]

Hawkins discusses the influence of globalization on operating procedures (controls versus market-based policies, quantitaties versus interest rates, short- versus medium-term rates), considers how operating procedures may need to be modified under exceptional circumstances, sets out some ways for central banks to improve liquidity in the markets in which they operate, and examines how central banks can best extract information about market expectations, and the extent to which globalization may be making this harder. "The choice between monetary aggregates and interest rates has long been a matter of debate among economists. The classic conclusion is that sticking to a money aggregate will stabilize the economy if shocks come from the real economy (that is, the IS curve) but sticking to an interest rate target is preferable if shocks affect the demand for money. Nowadays, most central banks choose to target interest rates rather than quantities. Interest rate changes normally have a clear effect on the cost of credit, with bank loan interest rates often immediately following changes in the operating target. For an economy with a fixed exchange rate and an open capital account, such as Saudi Arabia, a short-term interest rate is the natural target as it can be set with respect to the foreign interest rate."[5] Hawkins argues that the greater reliance on financial markets raises the issue of what a central bank can do to encourage liquid and efficient markets in both bank reserves and the security/instrument with which it transacts with banks; financial markets offer potentially useful information for central banks as they summarise the views of market players who have strong incentives to have well informed opinions; the term structure of government securities may be most useful for assessing policy expectations over the longer term and the credibility of the policy regime; a probability distribution of future interest rates and exchange rates can be extracted from option prices, assuming risk neutrality. “When both indexed and non-indexed bonds are issued and heavily traded, this can give a good measure of inflationary expectations. [...] Indexed bonds tend to be most useful for measuring medium-term expectations as longer-term indexed securities are generally bought and held by institutional investors. There may be a selection bias, however, in that indexed securities will be bought by investors with higher than average inflationary expectations. It is also not obvious whether an indexed bond should have a higher or lower risk premium. All this suggests that use of this approach may provide a better measure of changes in inflationary expectations than in the level. If the central bank is to extract information about *market* expectations from traded instruments, it must ensure its own transactions do not dominate the market. Transactions using repos do not directly affect prices in the bond market. Similarly, swap transactions in a liquid market do not as a rule directly affect the exchange rate.”[6]

Mihaljek discusses two complications for domestic monetary policy stemming from greater international integration of the emerging market economies: privatization-related capital inflows and large swings in export earnings. Mihaljek writes that the first feature that distinguishes foreign exchange inflows related to privatization and volatile export earnings is their size and variability; the second distinguishing feature of privatization-related inflows and volatile export earnings is the political economy of such inflows. “One should emphasise that large swings in export earnings are characteristic not only of commodity-exporting countries. Several emerging economies have exports concentrated on a few manufactured goods such as electronics, or on tradable services such as computer software and tourism. Such countries increasingly face large swings in export earnings due to unpredictable changes in world demand. Moreover, swings of this kind are more or less a permanent feature of their economies, given the high fixed costs associated with specialization. At the same time, many emerging market economies (e.g., India and China) have yet to face the challenge of large-scale privatization, while in others the ongoing programmes have not run their full course. Even in new member states of the European Union, for instance, the privatization of sectors such as transportation and energy has only just begun. Thus, in the period ahead privatization-related inflows and large swings in export earnings are likely to pose persistent challenges to monetary policy in the emerging market economies.”[7] Mihaljek reviews conventional monetary policy responses to foreign exchange inflows stemming from privatization, and looks at an alternative that has been successfully used in some transition economies: special privatization accounts. “Where privatization proceeds are placed in public sector accounts and how they are used has important implications for monetary policy. For instance, it is generally recommended that the privatization proceeds be fully reported in the official budget and not hidden in some extra-budgetary account. Nevertheless, the use of special privatization accounts, in particular if held with the central bank, does offer some advantages (from both monetary management and political economy perspectives) over the placement of privatization proceeds in the government budget."[8]

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COMPARING MONETARY POLICY OPERATING PROCEDURES IN ASIA

DORIN DOBRIŞAN

ABSTRACT. McCauley remarks that the transmission of the policy interest rate out the yield curve can be strongly affected by exchange rate expectations. Camen presents the current status of the reform of monetary policy in the context of economic and financial sector developments in Vietnam. Ito reviews critically policy actions of the Bank of Japan under a deflationary environment from 1998 to 2005. Bhattacharya contends that what makes India an especially attractive case to examine the generality of the theory is the fact that the monetary policy framework in India has changed twice since the 1980s.

McCauley finds that the fiscalisation of energy costs has reduced the challenge in Malaysia, while mostly just delaying it in Thailand; policy in both Malaysia and Thailand has taken as one of its goals some form of exchange rate stability; the contrast of Thailand's exchange rate outcomes with Malaysia's dollar peg is clear enough, but the interpretation of a stable effective rate as a policy goal requires further evidence. "The Malaysian and Thai central banks match their several goals with several instruments. Like major central banks, each periodically announces a target level for a short-term policy interest rate. In addition, these central banks occasionally intervene in the foreign exchange market and thus place changes in their own balance sheets between flows on the current and capital account, on the one side, and the exchange rate, on the other. Their interventions in the foreign exchange market may have particular effect owing to the relatively small scale of the underlying asset stocks, and the remaining restrictions on capital account transactions overseen by both central banks."[1] McCauley remarks that the transmission of the policy interest rate out the yield curve can be strongly affected by exchange rate expectations; intervention as a fractional instrument gains force from capital controls; while capital controls were sufficiently robust to afford Malaysia an independent monetary policy during a period of a pegged exchange rate, these controls were leaky. "In both cases, restraints on cross-border flows of capital may impede financial market development. For instance, some foreign investors in Thai government bonds report finding it difficult to manage their transactions in such a manner as not to run afoul of the 2003 constraints on holding onshore cash balances in baht. If this experience is general among foreign investors in Thai bonds, development of a more diverse investor base in them may have been discouraged. Restraints on cross-border capital flows also seem to work against diversity in the currency swap market, in which multi-year payment streams in local currency are exchanged for multi-year payment streams in US dollars."[2]

Camen presents the current status of the reform of monetary policy in the context of economic and financial sector developments in Vietnam, identifies key reform issues with respect to monetary policy, and gives a brief overview of principal economic and financial developments to situate monetary policy in the context of economic developments in Vietnam. Camen claims that restrictive fiscal policy and monetary policy have played an important role in bringing hyperinflation down in the 1980s and early 1990s; off-budget expenditures are for infrastructure investments that are primarily financed through government bond issues; the liberalization of lending rates for domestic currency loans did not lead to a noticeable increase in lending rates in Vietnam. "The structure of the Vietnamese financial system and the financial reform process give rise to a number of challenges for monetary policy: the structural transformation of the Vietnamese financial system makes it difficult to identify stable relationships between principal macroeconomic variables, with the implication that monetary policy needs to be conducted in the presence of important uncertainties; the thinness of money markets and the lack of financial instruments limit the scope of open market operations; bank lending is likely to be one of the principal channels of the monetary transmission process, although balance sheet problems of banks and enterprises are likely to limit its effectiveness; underdeveloped financial markets are likely to limit the effectiveness of the monetary transmission through interest rates; indications exist for a segmentation of the credit market, with SOCBs tending to apply more non-commercial practices while JSBs apply more commercial practices."[3]

Mariano and Villanueva describe recent trends in monetary policy, address five issues, describe for the Philippines and Indonesia the evolution of the monetary policy of the monetary policy transmission process as financial development progressed and external conditions changed over time, and discuss the effects of these factors on the monetary policy implementation strategy. "If the interest rate is used under conditions of uncertainty about the equilibrium real interest rate, policy errors are very likely. In countries with very high inflation rates and high and variable risk premia, the real interest rate is hard to measure. In addition, at any moment in time, emerging market economies are unlikely to be in their steady state, being continuously buffeted by exogenous shocks of all sorts; accordingly, the steady state or equilibrium real interest rate is difficult to determine and measure."[4] Mariano and Villanueva hold that inflation targeting is an alternative to a currency board or to dollarisation; in countries without liquid and deep financial markets and where term structure effects are absent or weak, changes in the exchange rate or land price may influence the private sector's future expectations. "The whole idea behind inflation targeting is that by committing credibly to a low and stable inflation target, a central bank could lower inflationary expectations for the future. Fiscal dominance makes this impossible, by not allowing the central bank much control over those expectations. In simple terms, why would firms lower their inflationary expectations when they know that large fiscal deficits and borderline unsustainable external debt positions essentially corner the monetary authority into an untenable position? Knowledge of such a cornered monetary policy will result in one-sided bets. Remove the twin dangers of monetization of the debt and the risk of creating inflation through devaluation, and inflation targeting has a shot. Fiscal authorities can do a lot by signaling deficit reductions in the future, especially if backed up by certain institutional moves that can engender credibility."[5]

Ito reviews critically policy actions of the Bank of Japan under a deflationary environment from 1998 to 2005. "When the economic recovery became stronger in autumn 1999 to spring 2000, the Bank of Japan became eager to terminate ZIRP. Governor Hayami indicated an early termination through several speeches. The first indication appeared in the Policy Board Minutes of April 2000. Indeed, the economic growth rate was higher, partly fuelled by the global ICT boom. ICT stock prices increased sharply from autumn 1999 to spring 2000. It looked likely that higher growth would fill the GDP gap and soon prices would start to rise. CPI inflation was still negative, but the degree of deflation was becoming less."[6] According to Ito, what monetary policy can do under deflation and ZIRP has become a hotly debated question in policy; monetary policy during the Hayami regime gives an impression that it was behind the curve in easing monetary policy, and timid in trying non-conventional policies. "Although the Bank of Japan bought equities from commercial banks in 2002, it was stated as a measure to stabilize the financial system and not part of monetary policy. Commercial banks had substantial holdings of equities on their books, and as the stock prices declined, they had become burdens as some marking-to-market had to be done and any losses had to be deducted from bank capital positions. However, selling stocks in the market would further drive the prices down, with a negative impact on the balance sheet. Therefore the Bank of Japan decided to purchase those equities from commercial banks outside the market. The Bank took pains to exclude the measure from the agenda of MPM. It was decided in the 'regular' Board meeting. The Bank was afraid that one the purchase of equities was regarded as part of monetary policy, the pressure to do more might increase."[7]

Bhattacharya contends that what makes India an especially attractive case to examine the generality of the theory is the fact that the monetary policy framework in India has changed twice since the 1980s. Bhattacharya provides a brief review of the evolution of the monetary policy framework in India, and examines to what extent the Indian experience can extend his knowledge about the role of the monetary policy framework in economic performance. "Until the early 1980s, the Indian economy was virtually a closed one. Prices of a significant number of commodities were administered in India at that time. To sustain these prices at a steady level, government subsidies were often necessary and this was one of the factors that led to a chronic

budget deficit. These deficits were either financed through ad hoc treasury bills or through indirect borrowings, mostly from nationalized banks. The first led to more or less automatic monetization. Net RBI credit to the government was the dominant factor behind reserve money expansion and the consequent expansion in money supply. To control the money supply, the RBI had to increase the cash reserve ratio (CRR) from time to time."[8]
Bhattacharya writes that the balance of payments crisis in 1990–91; one of the first important financial reforms that India introduced after the balance of payments crisis in 1990–91 was to change to a market-determined exchange rate system; after stabilization of the balance of payments crisis, the liberalization of interest rates in India gathered momentum. Bhattacharya maintains that significant changes took place in the Indian capital market during this period; the agreement between the RBI and the government of India to curb monetization was signed during this period; policies began to be more and more closed-loop in nature. "The transition to MIA was arguably a compromise outcome of monetary policy reforms. This approach has been followed since April 1998. In this approach, besides monetary aggregates, information pertaining to a range of rates in different financial market segments along with the movements in currency, credit, the fiscal position, merchandise trade, capital flows, the inflation rate, the exchange rate, refinancing and transactions in foreign exchange (which are available on a high frequency basis) is jux-

taposed with data on output and the real sector activity for drawing policy perspectives."[9]

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MEASURING AGRICULTURAL POLICIES

ROZI-LILIANA BEREVOIANU • ELENA TOMA
ANA URSU • ADRIAN RAHOVEANU TUREK

ABSTRACT. Hediger claims that the understanding and interpretation of the multifunctionality of agriculture and the goals of sustainable development substantially depends upon the historical development and cultural context. Botterill argues that since the introduction of agriculture into the international trade debate in the Uruguay Round of Multilateral Trade Negotiations, there has been increased focus on the nature of agricultural support policies in the developed countries. Mundlak determines whether the structural adjustment and liberalization process is enhancing or impairing the economic and institutional conditions conducive to technological innovation and greater productivity. Bonnen writes that current distributional issues differ greatly from the past.

Hediger claims that the understanding and interpretation of the multifunctionality of agriculture and the goals of sustainable development substantially depends upon the historical development and cultural context; it can be observed how agricultural policy goals have been influenced by changing societal concerns in a period of economic growth and global environmental degradation, and how this has cumulated to the concept of multifunctionality. "Despite the facts that multifunctionality and sustainability are guiding principles of current Swiss agricultural policy, the terms are frequently used in policy-related debates and the Swiss delegation in the GATT-Uruguay round has substantially contributed to creating and establishing the term in international policy debates, the number of Swiss contributions to the literature on multifunctionality is extremely small. Only few authors in Switzerland addressed the issue of multifunctionality, and even less investigated the relationship between the concepts of multifunctionality and sustainability."[1] Hediger notes that sustainability and MF are the key principles among which current agricultural policy in Switzerland is organized; agriculture traditionally had to serve multiple objectives that have been constitutionally mandated; on the international platform, the notion of multifunctionality has been introduced by the Swiss delegation and anchored in the negotiation results of the Uruguay Round Agreement on Agriculture. "The core idea of multifunctionality has a long tradition in Swiss agricultural policy. It has been established as a normative concept in the federal constitution which requests the Confederation to support agriculture in accomplishing its multifunctional tasks. As a consequence, the major part of research has been focused on partial aspects that were related to changes in agricultural policy, rather than to the concept of multifunctionality."[2]

Botterill argues that since the introduction of agriculture into the international trade debate in the Uruguay Round of Multilateral Trade Negotiations, there has been increased focus on the nature of agricultural support policies in the developed countries. Botterill proposes a two dimensional schema which divides values into “economic” and “non-economic”. “The non-economic category encompasses a broad sweep of possible issues from security to environmental protection. Although this is not entirely satisfactory in that it bundles together values which may themselves be in conflict, it reflects much of the tone of the international policy debate which often sets economic arguments in juxtaposition to the non-economic.”[3] Botterill uses the example of farm welfare and the trade-offs that the Australian government has reached in balancing economic objectives for farm businesses with the welfare needs of farm families; when economic arguments about the special conditions facing farming are combined with sentiments about the inherent virtues of farming as a lifestyle, the resulting mix of values is potent and can have a significant impact on policy. “The environmental impact of farming has come to the fore in Australia as externalities such as dryland salinity, algal blooms and soil erosion have become apparent. The 1990s were declared by the Australian Government as the Decade of Landcare in an attempt to increase farmers’ awareness of environmental problems on their properties and to encourage collective action by rural communities to address these issues. Other countries have similar concerns about the environmental impact of agriculture. [...] In the European Union, sustainability, food safety and concerns about animal welfare are considered to be important issues for the agricultural policy-maker to consider."[4]

Mundlak determines whether the structural adjustment and liberalization process is enhancing or impairing the economic and institutional conditions conducive to technological innovation and greater productivity; the underlying premise of Mundlak's analysis is that the technology actually used in production, referred to as the implemented technology, is not necessarily the most advanced technology, or frontier of the available technology; the effect of policies depends to a large extent on the nature of factor supply, and particularly on the response of factor supply to changes in the economic environment. "Often, the reason given for the co-existence is that producers do not have perfect knowledge about the new technique. This explanation is reasonable but it can not by itself account for the length of time that it has required to introduce the modern varieties and for the geographical variations in the pattern of their use. The green revolution is considered here as an example, indeed a very important one. Another example is the motorization of agriculture which has also taken a long time to be implemented. The explanation given here for the delayed response is the scarcity of inputs, such as fertilizers and irrigation facilities, needed for a full implementation of the modern technique."[5] Mundlak asserts that policies aimed at structural adjustments intend to change the economic environment and thereby they affect productivity;

agricultural productivity is a short name for the productivity of resources in agricultural production; technology is an abstract concept and not an observable quantity easily measured. "Technology is not merely an esoteric research topic for economists. It takes centre stage in the public discussion of agriculture. There are several reasons for the public interest in agricultural technology but to a large extent it is rooted in the desire to prevent food shortage. Thus, there are public experimental stations in each country, and there is a global network of experimental stations under the umbrella of the CGIAR. In addition to the public effort there is also private research in areas (such as in the development of chemicals or more recently in the area of genetic engineering) where the benefits of research and development can be captured."[6]

Bonnen writes that current distributional issues differ greatly from the past. "In the 19th century agriculture and rural society were perceived not only as disadvantaged but falling behind the urban sector in an industrializing society. As a consequence policies and programs were initiated to offset this disadvantage by investing in the infrastructure of agriculture. Social investments were made in rural and agricultural education, agricultural R&D, rural free delivery of mail, land and water development and, in the early decades of the 20th century, in extension education, highways, rural electrification, soil conservation, subsidized credit, and heavily subsidized land and water development. The agricultural commodity programs were established in the 1930s. All of this had the effect of encouraging growth by transferring resources into agriculture."[7] Bonnen argues that the commodity programs and subsidized water development for agriculture were once defensible investment decisions; it can be argued that the successful, large commercial farm of today does not need any public subsidies; existing institutional mechanisms seem to fall well short of internalizing the social costs of environmental degradation. "It is likely that the deregulation of trucking will aid farmers and rural firms. However, in the case of air transportation and the deregulation of railroads and buses, the low volume routes that invariably serve rural areas are being dropped out of the system. This has a particularly important impact in the plains and the west where large urban centers are few and far between. Again, the evidence is not conclusive, but there is a fair presumption that an impairment of the welfare of rural people and some parts of agriculture will result."[8]

Bonnen claims that the changing structure of agriculture is an artifact of past, private and public policies and power distributions that work to the greatest advantage of progressively fewer large farms and landowners; commodity programs built around voluntary production controls are now very costly and generally fail to reduce farm input due to slippage; while the early social investments in the development of rural America had distributive effects generally favoring rural and farm people, there was a very large spillover to the rest of society. "Growth allowed substantial net increases in attainment of equality as well as other values. A far smaller portion of the U.S. population today lives at a bare subsistence level of human welfare. The opportunity set of individuals has grown; there are fewer barriers to individual's access to human and biophysical resources. Human as well as biophysical capital per person has risen. The capacity of society to solve conflicts between equality and other values has grown."[9]

Botterill's study commences with a discussion of the multiple roles attributed to agriculture over time which are reflected in non-economic objectives for agricultural support, discusses the tensions between economic and non-economic objectives in the policy process, and introduces the policy map designed to illustrate the combination of values that is reflected in particular policy settings and to contribute to better understanding of why particular policy approaches emerge in some polities and not others. "Like much of the industrialized world in the 1980s and 1990s, Australia saw the rise of neoliberal economies as the preferred approach to policy-making. This was reflected in the focus of agricultural policy as more and more of the policy settings of earlier decades were dismantled and increasing emphasis given to programs to facilitate structural adjustment and improve farm productivity. During this era, the policy ideal to which all policy instruments were drawn was overall reduction in support for both the farm family and the farm business."[10]

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SUSTAINABLE DEVELOPMENT IN ECOLOGICAL MARKETING

CONSTANTIN ZAHARIA • IOANA ZAHARIA • NICOLAE TUDORESCU

ABSTRACT. Lozada contextualizes marketing within current environmental views, proceeds to explore some specific issues that have been levied regarding a key marketing function (product development and management), and examines the strategic repercussions of contemporary marketing approaches to ecological concerns. Schaefer claims that if all is not well with green marketing from a conceptual viewpoint, problems also arise with the spread of green marketing practice. Hiremath writes that the consequences of management for NTFP are determined by the political and socio-economic context in which such management occurs.

Lozada reviews how environmental concerns may be spawning alternative approaches to marketing strategy to deliver value-added and to potentially establish a source of competitive advantage. Lozada contextualizes marketing within current environmental views, proceeds to explore some specific issues that have been levied regarding a key marketing function (product development and management), and examines the strategic repercussions of contemporary marketing approaches to ecological concerns. “Green marketing imparts an ecologically proactive role on marketing organizations. It fosters not only sensitivity to the impact that marketing activities may have on the natural environment, but also encourages practices that reduce or minimize any detrimental impact. The philosophy of sustainable development provides additional impetus to green marketing by emphasizing that environmental protection does not necessarily negate economic prosperity, but encourages a rethinking of how we engage in marketing activities."[1] Lozada claims that in addition to the concept of eco-efficiency, *manufacturing for disassembly* has also gained momentum as the recycling of materials and energy and resource conservation are more plausible thanks to technological change. "Implementing a philosophy of sustainability in the practice of marketing would require businesses to become more sensitive to the efficient use of all resources over a longer period. In particular, the loss of natural resources may significantly affect a company's product line and overall production process(es). This change in orientation, from short- to long-term, would be part of any requisite structural changes (e.g., changes in corporate culture and communication and information systems). Perhaps the most persuasive argument is that waste represents costs to organizations, therefore waste reduction, reuse of materials, and recyclability are important cost savings activities in the long-run."[2]

Lozada contends that companies that have adopted some type of environmental accountability have found some benefits in the adoption of an ecological approach; consideration for the natural environment will have to be embedded in the product mix if a fully integrated green marketing strategy is to be achieved.

"The green image generates a more positive public image which can, in turn, enhance sales, increase stock prices, and open access to public capital markets. A green image may enhance the overall perception of product quality and when coupled with the environmental benefits inherent in a product and/or its use may provide the added value that consumers would favor."[3]

Schaefer maintains that a sustainable marketing system would have to be flexible, decentralized, and open to learning from environmental cues; experiments to deal with these environmental changes would emerge in various forms and at various places and multiple feedback loops would help to identify viable solutions and spread them. "Defenders of marketing practice might argue that it is unfair to lay all these environmental woes at the door of marketing as marketing does not create consumer needs (even those in an overly materialistic society) but merely reflects them. Therefore, if consumers were not willing to buy all these products offered in the market and happily accept or demand ever more and new consumer goods no amount of advertising or other marketing techniques could ever make them do so. There is some element of truth in this argument. Without latent consumer interest and demand no new product will succeed, no matter how sophisticated the selling techniques, and the large number of failed products in the history of marketing amply testifies to this effect."[4] Schaefer claims that if all is not well with green marketing from a conceptual viewpoint, problems also arise with the spread of green marketing practice. “While green marketing as practiced by industry has come in for criticism as being either insufficient given the magnitude and nature of the problem or even just a cynical self-preservation exercise, marketing holds out another promise in delivering change towards greater ecological sustainability. Social marketing means the use of marketing techniques to promote socially desirable behaviours, including environmental awareness and more sustainable behaviours. It attempts to re-educate and persuade consumers not to consume certain goods at all or to a much-reduced extent.”[5]

According to Schaefer, business and government organizations are generally structured along more hierarchical lines, which may be rather less conducive to learning; marketing networks communicate meaning in terms of values, technological knowledge, commercial knowledge, among others. “Material processes include the extraction and conversion of raw materials, transportation, use of finished goods, and disposal. Both of these can be seen as problematic from an ecological sustainability perspective. Current material processes are problematic because of their ‘linear’ rather than ‘cyclical’ nature and communications are problematic because of the meaning conveyed, which is often a promotion of material consumption and valuing material over non-material benefits. On a perhaps somewhat minor scale, communications may also be problematic because of the material use that is part of marketing communications.”[6]

Hiremath asserts that despite the long history of non-timber forest products (NTFP) harvest, it is only relatively recently that management of NTFP has caught the attention of conservation scientists as a means of ensuring forest conservation and as an alternative to conversion; the ecological effects of harvesting NTFP can be varied, and the impacts can range from the level of genes to individuals and populations, communities and ecosystems, all of which have important consequences. “Extraction of NTFP goes through well-recognised phases: subsistence economies that depend on NTFP for a large part of their subsistence and livelihood needs put a high value on NTFP; as income levels rise, so too does the opportunity cost of foraging for NTFP; and in market economies the value of forests ceases to lie in NTFP, and is replaced by other values such as carbon sequestration or the conservation of the unique products of evolution.”[7] Hiremath writes that the consequences of management for NTFP are determined by the political and socio-economic context in which such management occurs. “The alteration of the genetic composition of wild populations from repeated selective harvest of the biggest, or most productive, individuals can deplete the vigour of the wild gene pool. This in turn can compromise the long-term survival of the species; it can also compromise the vigour of domesticated and cultivated populations of species drawn from such depleted wild stocks. Harvest of certain NTFP can lead to ecosystem degradation, for example, nutrient depletion from the export of large amounts of nutrient-rich plant parts. This can affect not only the availability of desirable NTFP species, but also jeopardize other values that society derives from ecosystems, such as soil and water conservation or carbon sequestration."[8]

Schaefer uses the analogy of a living system to explore the requirements for a sustainable marketing systems and barriers to sustainability; consumers demand more environmentally responsible products and production processes. "Marketers react flexibly to these consumer demands, changing products and processes to achieve the same consumer benefits with less environmental detriment. Marketers that do not respond to these market demands are perceived to be environmentally irresponsible by consumers and are eventually pushed out of a competitive market. This process constitutes a rebuilding of a more sustainable market system from below, whereby a snowball effect of demand for more environmentally benign products and processes and increased monitoring at all levels drives pro-environmental change through the entire supply chain."[9] Diaz reasons that, in the latest years, companies are in a new competence scene facing not only economic and social rules, but also ecological ones, and analyzes the way a company must direct its management toward the new relationship between firm-natural environment-stakeholders and the ecological marketing strategies (product, prize, promotion and place). Diaz presents the mechanisms proposed by International Organizations, which make it easy to implement an Environment Management System, in a voluntary way, considering its similarities and differences.[10]

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CRIME, PUNISHMENT, AND SOCIETY

ELENA-MARIA TUDOR

ABSTRACT. Criminal punishment should be understood in retributive terms as a response to wrongdoing that seeks to communicate deserved censure and to induce repentant understanding (Duff). Punishment invokes a primordial understanding of state power that remains highly credible (Caplow and Simon). Large surplus labour populations are threatening to market economies, and economic elites within these nations use imprisonment to manage the underclass when unemployment increases (Rusche and Kirchheimer).

The transformation from traditional rural and agrarian lifestyles with high levels of informal social control into industrialized urban economies results in role confusion, increased rates of crime, and social disruption. The type of legal system may influence the use of punishment within a society (e.g., adversarial legal systems might have higher rates of imprisonment than their less confrontational counterparts); newly independent nations may attempt to enhance their political legitimacy through punitive crime control strategies. Richer nations share more homogeneous market conditions, and the use of punishment is therefore less likely to be driven by poverty. Imprisonment research must control for crime, yet there are few reliable and valid indicators of property crime in large samples of nations. Ruddell outlines the bivariate and multivariate analyses that evaluated the relationships between punishment and social and political factors in the 100 richest nations; consistent with punitive crime-control philosophies there was a strong positive association between retention of capital punishment and imprisonment. Common law systems were also significantly associated with imprisonment rates, but nations with civil law systems had a non-significant relationship. Low imprisonment rates in many European nations may be a consequence of bureaucratic traditions and corporatist political arrangements that have insulated public officials from public demands for punishment during eras of disruption. Future empirical tests of punishment that examine the influence of economic factors might include alternative measures of economic stress, including bankruptcies, consumer debt, bank failures, or stock market volatility.[1] Criminal punishment should be understood in retributive terms as a response to wrongdoing that seeks to communicate deserved censure and to induce repentant understanding.[2] Caplow and Simon maintain that punishment invokes a primordial understanding of state power that remains highly credible. "Imprisonment, especially when promoted as incapacitation, is something government knows it can accomplish."[3] Declining public confidence in social welfare programs and state interventions in the national economy are evidence of that weakness, as are periodic surges in the crime rate that have "diminished the prestige of governments in their most traditional function of maintaining civil order."[4] Today's center is little more than a floating set of preferences "on a vast range of issues charted by polls and pundits."[5] If the postmaterialist politics tends toward issues of good and evil, "crime is a natural metaphor for evil. [...] For political mobilization around law and order to produce a sustained increase in imprisonment, other conditions must be present."[6] Caplow and Simon provide a detailed analysis of how changes in the institutions of parole and probation have enhanced the system's capacity to incarcerate; the authorities must decide early on whether to formally file charges. "This may in some cases result in a decision against arrest, but we suspect far more often it results in a decision to move forward."[7]

Cotterrell states that, in order to understand law, "the legal sociologist has to understand it as a participant, or as a participant does; or rather, as many different kinds of participants do – lawyers or citizens, for example, living in the world of law."[8] Bourdieu claims that in order to construct a model of the game, which will not be the mere recording of explicit norms, nor a statement of regularities, "while synthesizing both norms and regularities, one has to reflect on the different modes of existence of the principles of regulation and the regularity of different forms of practice; there is of course the habitus, that regulated disposition to generate regulated and regular behaviour outside any reference rules; and in societies where the work of codification is not particularly advanced, the habitus is the principle of most modes of practice."[9]

Rummel holds that “the more constrained the power of governments, the more power is diffused, checked, and balanced, the less it will aggress on others.”[10] Sutton examines the longitudinal relationships between labour market variables and imprisonment in small samples of affluent democracies, and notes the main effects of labour market variables on imprisonment trends as well as statistical interactions.[11]

Moore holds that if criminal law is a functional kind whose function is to attain retributive justice, by punishing all and only those who are morally culpable in the doing of some morally wrongful action, then we are criminally responsible simply as moral agents, for the moral wrongs that we commit.[12] Large surplus labour populations are threatening to market economies, and economic elites within these nations use imprisonment to manage the underclass when unemployment increases.[13] Stern writes that “many developing countries are living with the consequences of a criminal justice system, based on retribution, imposed on them by the former colonizers.”[14] Duff argues that to say that we are criminally responsible as citizens to our fellow citizens does not say much about what we can be held criminally responsible for. There are two debates about the proper objects of criminal responsibility. “One concerns the aspects of the agent on which criminal responsibility should be focused, or in which it should be grounded: should it be grounded in our actions; or in the choices from which actions flow; or in the character traits that actions may reveal? [...]

The other debate concerns what it is about actions (or choices, or character traits) that can make them proper objects of criminal responsibility: what kinds of action (choice, character trait) do we have good reason, at least in principle, to criminalize?"[15] If we are to have a system of criminal law, rather than relying on other modes of legal regulation and harm-prevention, "it should because we take certain kinds of wrongdoing seriously enough, qua wrong-doing, to think that they should be salient in our system of social regulation – that that system should identify and condemn them."[16] "Public" wrongs are those that properly concern the public (the polity as a whole) rather than being the business only of those immediately involved. "It will not do to say that 'public' wrongs are those that injure 'the public' as distinct from identifiable individuals: that would distort our understanding of the criminal wrongfulness of paradigmatic victimizing crimes; the law would not condemn the rapist for the wrong done to his victim, but for his action's effects on, or implications for, 'the public'."[17]

Schatzki maintains that much social theory operates with a representational theory of action that conceives of action as caused by representational entities – beliefs, desires, needs, goals and so on as causes of action. "Each of these mental states is a representational entity (whose content is the thing believed, desired, needed, or striven for), which combines with other such representations to bring about action. The representational approach need not, however, confine itself to mental states described in common locutions. It can also marshal such representations familiar to social science as values, norms, schemes, recipes, and means-ends chains as well as representations specified in more technical language, as in contemporary cognitive science. The prominence of a flock of such explanations in philosophy, cognitive science, psychoanalysis, anthropology, economics, political science, and sociology attests to the power of the representational approach."[18] Bouveresse maintains that we obey rules because we have learnt to do things in particular ways. "As Wittgenstein himself says, it is a mistake to assume that a rule by itself leads somewhere, regardless of whether people follow it or not. And it is also a mistake to assume that the rule itself can select one single possibility in an abstract space which is not structured and limited in advance by the propensities, aptitudes and reactions which constitute the links between the subject and the human world, or the universe of human practices in general."[19]

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FINANCIAL PERFORMANCE AND REGULATION

CRISTIAN GRĂDINARU

ABSTRACT. Atkinson et al. argue that increasing complexity of financial services provision has made it more difficult for the average consumer to be sure they have made appropriate provision. Fujiwara et al. review how monetary policy should be conducted in a liquidity trap caused by the zero nominal interest rate bound. Collard notes that, in recent decades, access to financial services has become much more widespread in the UK. Carbo et al. outline the nature and causes of financial exclusion, highlights the extent of exclusion across Europe and discusses the various policy/industry responses to tackling financial exclusion.

Financial constraints increase firms' propensity to save cash out of incremental cash flows.[1] Fund companies dismiss managers in a manner consistent with a model in which fund companies gradually learn about manager's abilities through time.[2] Outcome orientation is the extent to which the business unit emphasizes action and results, and has high expectations for performance.[3] Restating firms are smaller, less profitable, slower growing, more highly levered and received more qualified audit opinions than their industry counterparts.[4] Data quality champions provide political support, keep participants informed, and allocate resources to data quality projects.[5] The increase in growth due to liberalization is slightly larger than 1 percentage point after controlling for a number of variables.[6]

Hodge et al. claim that in the presence of the qualification, investors believed that the accounting change was relatively strategic, they discounted the income effect of the accounting change, and their assessments of future performance were significantly below their assessments of current performance. Hodge et al. use an experiment because information about the consequences of accounting-choice qualifications cannot be collected from archival data given that such qualifications are virtually non-existent for publicly-traded companies; investors seemed to interpret the qualification to mean that management was strategically understating performance in the current year and that the firm's performance would decrease significantly over the next three years.[7] Brown believes that earnings surprise research can conduct more powerful tests by not assuming that all firms quarterly earnings series follow the same time-series model.[8] The use of abnormal stock returns as a composite measure of financial distress, conditioning on the belief that stock prices in an efficient market are able to reflect firms' overall healthiness.[9]

Conrad considers the role of accounting, in particular CCA (current cost accounting), in influencing perceptions of financial performance and consequently regulatory decisions in utility industries over the past 25 years. Conrad examines the accounting practices of nationalized industries, and how privatization affected accounting in utilities, and concludes with a discussion of more recent developments in relation to regulatory accounts and their role in regulatory decision-making.[10] Rigorous monitoring of banks and building societies in respect to the provision of accounts is more important than whether self-regulation or legislation has been used.[11] Kempson et al. maintain that regulated money-lenders operate to meet their specific needs since people borrowing from these sources are most likely to be those with a need for credit that cannot be met by mainstream sources.[12]

Atkinson et al. argue that increasing complexity of financial services provision has made it more difficult for the average consumer to be sure they have made appropriate provision; although financial inclusion and financial capability are often linked in debates, there had been no attempt to extent to which they are actually associated in practice; individuals may have relative skills and relative weaknesses and these might well depend in part on their circumstances. “The statistical approach has created a new measure, based on the answers to a wide range of questions. It provides us with a relative measure, and does not attempt to identify a group whose financial capability may be said to be ‘too low’, ‘inadequate’ or ‘failing’. In view of this, it is most appropriate to analyse these factor scores in terms of their distributions. We can then ask questions such as whether there was a group of people who were consistently failing to exhibit behaviour that was even nearly as capable as the majority of people, or whether most people behave very similarly in terms of a particular aspect of financial capability.”[13] According to Henry, the stock market responds more favorably to the announcement of stabilization programs directed at high inflation than to those directed at moderate inflation, regardless of whether the stabilization program is exchange-rate-based or not; if the stock market is rational, then it may assign a lower probability of success to a disinflation program that is announced on the heels of a failed program. "To the extent that stock market responses to the announcement of a disinflation program predict the expected net benefit that will accrue to shareholders as a result of reducing inflation, they should be negatively associated with future changes in inflation. [...] Stock price responses to disinflation announcements have some unconditional predictive power for what will happen to inflation in the year following stabilization efforts."[14]

Fujiwara et al. review how monetary policy should be conducted in a liquidity trap caused by the zero nominal interest rate bound, briefly summarize the Japanese Economic Model (JEM), test the effectiveness of the conventional wisdom with a large-scale dynamic general equilibrium model, confirm the effectiveness of such a policy rule to commit to lower future nominal interest rates through some variation on price-level targeting, and discuss how the dimension of uncertainty increases in a liquidity trap. "Changing household expectations raises the price level even in a liquidity trap. Therefore, quantitative easing with a fiscal commitment means that the liquidity trap is excluded from rational expectations equilibria, and escape from a deflationary trap becomes theoretically possible. [...] The government declares that the exchange rate is to be pegged to a crawling exchange-rate target, where the exchange rate depreciates by the difference between the domestic target level of inflation and that of the foreign country."[15]

Collard notes that, in recent decades, access to financial services has become much more widespread in the UK; providing cheaper credit to people on low incomes is probably the biggest challenge in tackling financial exclusion; as with consumer credit, insurance provision has moved increasingly towards risk-reflective pricing. "Widening access to affordable credit is likely to take longer. The new breed of community-based loan schemes and 'quality' credit unions have great potential to deliver affordable credit to people on low incomes, and provide a solid foundation on which the government's growth fund can build. We are unlikely to know the impact of legislative changes on high-cost commercial lenders for some time, and the possibility of reducing the cost of credit through automated payment methods, such as an improved direct debit system, has only recently come under serious consideration."[16] Carbo et al. outline the nature and causes of financial exclusion, highlights the extent of exclusion across Europe and discusses the various policy/industry responses to tackling financial exclusion; insurance exclusion becomes increasingly problematic as the range of risk cover possibilities extend; while the economic benefits of liberalization and greater competition continue to be sought, the free market unaided does not appear capable of solving the financial exclusion problem. “The general approach to tackling financial exclusion in Europe has been somewhat ad hoc. This, to a certain extent at least, reflects the disappointing role of the European Commission (EC) in dealing with financial exclusion issues. The EC has affirmed, via the European Social Agenda, the concept of a social policy that embraces increased inclusion as a major, ‘ongoing target’. Improved forms of governance that bring together the EU member states, local and regional authorities, non-governments organizations and enterprises of all kinds are seen as the way forward.”[17] Carbo et al. state that, in many countries, the increasing move by governments towards using electronic methods to make benefits payments have helped to attenuate the need to tackle financial exclusion; governments have sometimes acted as a mediator in order to facilitate a response to tackle exclusion, in other countries governments have legislated. “As financial services firms ‘desert’ particular geographical localities and customer segments, information for assessing respective risks is reduced; asymmetric information problems worsen. Concomitantly, the ‘risk pools’ for such marginalized groups may also reduce for individual financial services firms; risk becomes less predictable and less amenable to risk pooling.”[18]

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THE DETERMINATION OF UNEMPLOYMENT BENEFITS

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ABSTRACT. Røed and Zhang use a flexible hazard rate model with unrestricted spell duration and calendar time effects to analyse a dataset including all Norwegian unemployment spells during the 1990s. Starrin and Larsson's study contributes to the understanding of women's unemployment with emphasis on individual reactions in terms of their significance and context, and it was carried out within the methodological tradition of grounded theory. Raaum and Røed remark that labor market conditions at the time and place of potential entry into the labor market are shown to have a substantial and persistent effect on adult employment prospects.

Lalive et al. study how changes in the two key parameters of unemployment insurance, the benefit replacement rate (RR) and the potential benefit duration (PBD), affect the duration of unemployment. To identify such an effect Lalive et al. exploit a policy change introduced in 1989 by the Austrian government, which affected various unemployed workers differently: a first group experienced an increase in RR; a second group experienced an extension of PBD; a third group experienced both a higher RR and a longer PBD; and a fourth group experienced no change in the policy parameters. Unemployed workers react to the disincentives by an increase in unemployment duration. Lalive et al. use their parameter estimates to split up the total costs to unemployment insurance funds into costs due to changes in the unemployment insurance system with unchanged behaviour and costs due to behavioural responses of unemployed workers.[1] Røed and Zhang use a flexible hazard rate model with unrestricted spell duration and calendar time effects to analyse a dataset including all Norwegian unemployment spells during the 1990s. The dataset provides a unique access to conditionally independent variation in unemployment compensation; a marginal increase in compensation reduces the escape rate from unemployment significantly, irrespective of business cycle conditions and spell duration. Men are more responsive than women with respect to marginal changes in compensation; women are more responsive with respect to benefit exhaustion.[2] Bennmarker et al. note that in 2001 and 2002 Sweden introduced several unemployment insurance reforms. A major innovation in the first reform was the introduction of a two-tiered benefit structure for some unemployed individuals; this system involved supplementary compensation during the first 20 weeks of unemployment. The 2002 reform retained the two-tiered benefit structure but involved also substantial benefit hikes for spells exceeding 20 weeks. The reforms had quasi-experimental features where the "treatments" differed considerably among unemployed individuals; the reforms had strikingly different effects on job finding among men and women. The two reforms in conjunction are estimated to have *increased* the expected duration of unemployment among men but to have *decreased* the duration of unemployment among women.[3]

Starrin and Larsson's study contributes to the understanding of women's unemployment with emphasis on individual reactions in terms of their significance and context, and it was carried out within the methodological tradition of grounded theory. Thirty-six unemployed women were interviewed; the reactions to unemployment were seen in relation to two, systematically generated, core variables: "the relation to wage labour" and "the relation to alternative activities"; four different groups of unemployed were identified in light of their relations to these two core variables. They were called "the give-uppers", "the clenchers", "the refocusers" and "the ambivalents"; serious effects of unemployment were found among the give-uppers and the clenchers.[4] Katz and Meyer examine the impact of the potential duration of unemployment insurance (UI) benefits on unemployment in the United States, and use a large sample of household heads to examine differences in the unemployment spell distributions of UI recipients and nonrecipients. Sharp increases in the escape rate from unemployment both through recalls and new job acceptances are apparent for UI recipients around the time of benefits exhaustion; such increases are not apparent at similar points of spell duration for nonrecipients. Katz and Meyer's analysis of accurate administrative data from 12 states indicates that a one week increase in potential benefit duration increases the average duration of the unemployment spells of UI recipients by 0.16 to 0.20 weeks.[5] Hayes argues that Lucas contradicts both Keynes and Pigou in asserting that there are always immediate vacancies for unskilled labour; if voluntary unemployment is re-defined appropriately, the prefix "involuntary" is dispensable, not because all unemployment is voluntary, but because it is all involuntary.[6]

Raaum and Røed remark that labor market conditions at the time and place of potential entry into the labor market are shown to have a substantial and persistent effect on adult employment prospects; individuals who face particularly depressed local labor markets when they graduate from secondary education, are (other things equal) subject to relatively high rates of non-employment during their whole prime-age work career. Building on a unique combination of micro and macro data from Norway, Raum and Røed show that these effects are robust with respect to model specification and conditioning variables, and that they are not limited to individuals with a particularly disadvantaged background.[7] Lee and Lee analyse job-training effects on Korean women for the period January 1999 to March 2000, using a large data set of size about 52,000, and employ a number of estimation techniques: Weibull MLE and accelerated failure time approach, which are both parametric; Cox partial likelihood estimator, which is semiparametric; and two pair-matching estimators, which are in essence nonparametric. Job training for Korean women increased their unemployment duration; the trainings were not cost-effective in the sense that they took too much time "locking in" the trainees during the training span, compared with the time they took to place the trainees afterwards.[8] Atkinson et al. examine the evidence from models of unemployment duration concerning the effects of unemployment benefits on incentives to work in Britain. Widely accepted results of a small but significant benefit effect are reproduced using a sample of 1,231 unemployed men; these results are only found when benefit receipt is assumed to follow a hypothetical pattern which is shown to be unrealistic and overgenerous (when more realistic calculations of benefits are used, no benefit effect is found). Search theory is of little help in determining the choice between competing functional forms and explanatory variables.[9]

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CONCEPTS AND MEASUREMENTS IN FOOD AND AGRICULTURAL POLICY

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ANA URSU • ADRIAN RAHOVEANU-TUREK

ABSTRACT. Bonnen says that economic welfare is a function not only of the amount of goods and services available but also of their distribution. Mundlak develops a conceptual framework for analyzing the ways in which changes in the economic environment modify factor productivity, and focuses on the technology actually used in production (implemented technology) rather than the generation of technology. Botterill proposes a means for identifying the nature of the balance that is struck by governments between different values competing for support through agricultural policy settings, focuses on the different values that commonly arise in the development of agricultural policy, and suggests an approach which may clarify why different governments arrive at different policy settings in attempting to achieve an acceptable balance between competing interests.

Bonnen says that economic welfare is a function not only of the amount of goods and services available but also of their distribution; what is equitable depends on society's social preferences and the possibilities that exist for tradeoffs in society between various degrees of equality and the other values held in society. "Our present economic difficulties in farming arise out of failures of macroeconomic policy that have created an interest driven explosion in farm costs while undermining demand for agricultural exports. It leaves the world with a substantial excess capacity for agricultural production. This has deflated U.S. farm assets, especially land values, in turn eroding the net worth and financial capacity of all commercial farms. Those who are highly leveraged are exposed, if not in serious trouble, and have substantial cash flow problems. The problem varies greatly across regions and by type of farm enterprise. Except for the middle-size group of farmers, who are not earning adequate returns, the long-term problem of commercial agriculture is a destructive macro-economic policy and excessive market instability."[1] Bonnen notes that a set of distributional issues are created by the externalities generated by the agricultural sector for which today political accountability is being pressed; a set of externalities is generated by the nonagricultural sector and impact agriculture; a number of distributional issues are raised by the impact on agriculture of the macroeconomic policies of the U.S. "The central causal factor in concentration of agricultural production is tax policy. U.S. tax policy has been modified to benefit commercial farmers, especially the larger and wealthier farmers and nonfarm investors. Tax policy provides most of the financial incentive for the expansion of farms beyond the size where there are any additional social returns to scale. Tax laws are also a source of farmers' tendency to over invest in productive capacity adding to the instability of U.S. agriculture. These incentives include special treatment of assets, accelerated depreciation, cash accounting, and special expense rules."[2] Bonnen claims that agricultural markets are interdependent worldwide: the demand for U.S. farm output has become more responsive to price and the supply of farm output is more responsive to the prices that U.S. farmers pay for their inputs and receive for their product. "We are headed toward a bimodal distribution if nothing is done to protect the middle range of family firms, many of which are not fully competitive economic units. Off-farm employment and income constitutes the primary income source for the large group of small farms and often provides important protection against the risks of farming and low returns in the other two groups. Farming in the U.S. is no longer the homogenous, low-income, low-return sector it was in the 1930s; major differences now exist between farms in efficiency and economic needs. The price support programs provide limited assistance to the average farmer while producing major windfalls for the largest farms."[3]

Mundlak develops a conceptual framework for analyzing the ways in which changes in the economic environment modify factor productivity, and focuses on the technology actually used in production (implemented technology) rather than the generation of technology. "The concept of productivity, regardless of the actual method used in computing productivity, calls for a comparison of changes in outputs and inputs. In that, it is implicitly assumed that regularity in the relationship between inputs and outputs prevails over time or across producers so that the results of one comparison are valuable in predicting the response of output to input changes in another experiment. It is this repetitious property that justifies the study of such input output relationships, usefully summarized in terms of the production function."[4] Mundlak contends that not all output is produced by the most productive techniques; there are considerable differences in the efficiency of production between farmers; a similar consideration is applied to the global distribution of agricultural production. "In general, the analysis of production assumes, implicitly or explicitly, that the technology consists of a single technique, characterized by a production function. In this framework, when there is a change in technology, producers replace the old technique with the new one. However, this assumption is inconsistent with the data which show that the process of transition from old to new techniques takes time (and generally a long time) and in the process different techniques coexist. Therefore the removal of this assumption has important consequences for our understanding of producers' behaviour, in general and more specifically, in their implementation of new techniques."[5] Mundlak claims that the pace and level of the transition to the modern variety were determined by the availability of the capital, or quasi-fixed, inputs; the expansion of their supply required resources and those had to be taken from other productive uses; the production of a given commodity or service can be decomposed into a set of elementary activities or techniques; the concept of physical efficiency is based on a comparison of a particular production plan with the efficiency frontier. "Efficiency-frontier production functions are fitted to connect the points with largest output for given inputs, but efficient points under the initial technology may be ruled as inefficient in a sample of mixed technologies. The problem of identifying the technology and the constraints is crucial for the efficiency frontier approach, but it is also important to all empirical analyses."[6]

Mundlak writes that investing in research and development increases knowledge and improves the available technology; the increase in capital intensity makes it possible to preserve the rate of return on capital as the capital labour-ratio increases. "Agricultural productivity is affected by the physical environment. Variables such as average rainfall, temperatures, length of growing seasons, type of soils are of permanent nature and as such affect the decisions with respect to the crops to be grown and the methods of production and should be included in analyses based on cross-section data. The effect of the permanent component of the environment can be evaluated by allowing for 'unit effect'. For instance, in cross-country analysis, we can introduce a country effect (country dummies) to allow for the permanent component of the environment. The problem is that such a country effect represents other variables as well. Thus, as a general principle, it is desirable to include the more important variables explicitly."[7]

Botterill proposes a means for identifying the nature of the balance that is struck by governments between different values competing for support through agricultural policy settings, focuses on the different values that commonly arise in the development of agricultural policy, and suggests an approach which may clarify why different governments arrive at different policy settings in attempting to achieve an acceptable balance between competing interests. “Agriculture is different from other forms of economic activity because: (1) there is an inelastic demand for food and as economies develop, farm incomes do not keep up with general economic growth; (2) farming is subject to climatic uncertainty and occasionally other natural calamities beyond the control of the farmer; (3) farmers are generally price takers and, particularly those dependent on export markets, are subject to fluctuating prices; (4) farming is an essential activity and it is only fair that farmers share in national wealth, and (5) the family home is often inseparable from the faculty business and therefore social considerations cannot be completely removed from agricultural policy.”[8] Botterill writes that, in recent years, the scope of non-economic considerations in agricultural policy has expanded beyond agrarianism; in order to understand policy outcomes in terms of the values they represent, it is important to explicitly recognize economic efficiency as a value like any other; once the values of importance to the community are identified, governments can direct policy instruments to addressing these concerns. “In 1952, in the context of concerns about the Australian balance of payments, Commonwealth and State agriculture Ministers agreed a set of production targets aimed at stimulating increased agricultural production. The policy approach had shifted from being primarily concerned with the welfare of farmers to a focus on stimulating farm production and investment. In spite of the change in official purpose, the policy settings were little changed with a plethora of stabilization, price fixing, import protection, orderly marketing and other schemes in place. Industries were also offered protection from substitutes – for example the dairy industry received protection in the form of quotas on the domestic production of margarine and the associated requirement that any imports of this product be dyed pink."[9]

Botterill claims that the *farm business model* is characterized by an emphasis on support for the farm business; the *agrarian model* encompasses support to both the farm business and the farm family; the *welfare model* suggests an emphasis on the welfare needs of the farm family with less focus on supporting the farm business; the *free market model* relies on market forces to shape agriculture. "In terms of instrumental policy learning, frequent revisiting of the definition of exceptional drought suggests policy-makers recognized the limitations of existing approaches and were seeking to improve on earlier attempts at identifying areas which would be eligible for support. The rejection by the rural policy community of the construction of drought as a natural disaster and the acceptance of a risk management approach to drought policy is an example of social policy learning.

Although the reasons for removing drought from the natural disaster relief arrangements were varied, the decision was followed by a growing consensus that drought in Australia needed to be viewed from a different perspective."[10]

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INVESTMENT OPPORTUNITY, CORPORATE FINANCE, AND MANAGEMENT DISCLOSURES

ADELA MĂRCULESCU

ABSTRACT. Lai studies the association between investment opportunity and audit quality: high investment opportunity firms bear high agency cost that requires a higher level of audit quality, which will more likely constrain earnings management of those firms. Ruffino and Treussard contend that pursuing optimal life-cycle portfolio policies is technologically feasible but it represents a significant burden for individuals and financial firms acting as fiduciaries. Aivazian et al. write that managerial control issues may be less severe in bank centric market characterized by constant monitoring of corporate activities by lending officers.

Hutchinson argues that according to agency theory the corporate board is an important internal governance mechanism, and identifies the variables that influence the board structure adopted by firms and the subsequent relationship to the firm's performance; firms' investment opportunities are strongly associated with a higher proportion of executive directors on the board (when testing the efficiency of the board the results show that the negative relationship between a firm's investment opportunity set and firm performance is weakened at higher levels of non-executive director board domination).[1] Jaggi and Gul examine the association between IOS, FCF, size and debt on the basis of a sample of 1869 observations from 1989 to 1993 for non-regulated

U.S. firms: there is a significant positive association between FCF and debt level for firms with low IOS, thus providing support for Jensen's "control hypothesis"; the negative association between high IOS and debt as suggested in the literature is significant for small firms only (small firms are likely to finance their growth more with equity capital than debt); there is some support for the expectation that the positive association between debt and high FCF for low IOS firms is more pronounced for large firms.[2]

Lai studies the association between investment opportunity and audit quality: high investment opportunity firms bear high agency cost that requires a higher level of audit quality, which will more likely constrain earnings management of those firms. Lai reports that high investment opportunity firms are more likely to have more discretionary accruals but they are less likely to have the same when they also have Big 5 auditors; there is a higher (lower) proportion of high (low) investment opportunity firms that have Big 5 auditors (in comparison with low investment opportunity firms that have Big 5 auditors, high investment opportunity firms that have Big 5 auditors have less discretionary accruals but higher perceived audit quality).[3] Ruffino and Treussard note that in an environment with stocks and short-term debt, random changes in the risk-reward frontier produce hedging demands for equities, implying that portfolio policies supporting optimal life-cycle consumption are rarely mean-variance efficient. Ruffino and Treussard contend that pursuing optimal life-cycle portfolio policies is technologically feasible but it represents a significant burden for individuals and financial firms acting as fiduciaries (investors often rely on relatively simple investment heuristics, most often age-based portfolio policies that rebalance the investor's portfolio as a function of age alone). Ruffino and Treussard find that (i) the welfare losses associated with optimal age-based policies are often negligible, so that the trade-off between the first-best and these simpler policies likely favors the latter, and that (ii) not only do initial age-based portfolios display the same overall pattern as first-best portfolios but they are also always within the same order of magnitude.[4]

Goyal et al. examine how investment opportunity proxies change when there is an exogenous shock to the investment opportunity set; investment opportunities in the U.S. defense industry increased substantially during the Reagan administration of the early 1980s.[5] Hegde and McDermott document an overall increase in liquidity following index addition, and find an increase in trading volume, trade frequency, and quoted depth, and a decrease in bid-ask spreads for firms added to the index between 1993 and 1998.[6] When firms have more internally generated funds than positive net present value projects, debt forces the managers to pay out funds that might otherwise have been invested in negative net present value projects.[7]

Myers divides the market value of a firm into two parts: the present value of assets already in place and the present value of future investment and growth opportunities; the value of growth opportunities depends on future discretionary investments, while the value of assets in place does not.[8] Managers should seek ways to increase stock liquidity, because it is an important element in the market valuation of real assets.[9] Aivazian et al. write that managerial control issues may be less severe in bank centric market characterized by constant monitoring of corporate activities by lending officers.[10] Lev points to the widening gap between book income and tax income and the large number of earnings restatements in recent years; there are systematic deficiencies in accounting standards and governance systems that generate financial information of public companies.[11]

Carey claims that in the profession's early days, "hanging out his own shingle" sufficed for an outward mark of independence. "Progress brought problems, and one of them in the auditor's realm was how the attribute of complete intellectual honesty might be recognized as something additional to the fact of his being engaged in professional public practice. So there arose a quest for signs – signs by which any lack of independence might be recognized. [...] The profession has gradually compiled precepts and conditions to guard against the *presumption* of loss of independence. 'Presumption' is stressed because insofar as intrinsic independence is synonymous with mental integrity, its position is a matter of personal quality rather than of rules that formulate certain objective tests."[12] Herrmann et al. document that the Japanese stock market, while accurately reflecting the persistence of parent-only earnings, underestimates the extent to which subsidiary earnings persist into next period's consolidated earnings.[13] Scott states that more and more of the responsibility for effecting economic adjustments has come to be shared between accounts and the market. "At the same time accounts have developed into a position of importance as an instrument of administrative control. The steadily increasing importance of accounts has been coupled with a declining significance of the market. [...] Yet, accounts still are dependent upon the market. Is this dependence a necessary and unavoidable relationship? If the market become a subordinate institution, will accounts still be subordinate to it?"[14]

Managers make substitutions between real and accounting variables when smoothing earnings.[15] Managers rely on financial reports to communicate with shareholders.[16] Kasznik and Lev find a negative market response to an earnings information path that warns investors about upcoming negative earnings news compared to providing no warning.[17] Investors assign less weight to analysts' forecast revisions made during the quarter than to earnings surprises occurring when earnings are announced.[18] Ball et al. operationalize financial reporting quality as timely incorporation of economic losses: it is misleading to classify countries by accounting standards, ignoring reporting incentives (financial reporting quality is sensitive to the incentives of both managers and auditors).[19] Lack of transparency shifts firm-specific risk to insiders and reduces the amount of firm-specific risk absorbed by outside investors.[20]

Auditors are more likely to detect and correct overstatements then understatements because the legal liability associated with undetected overstatements is perceived to be higher.[21] Maines and Wahlen write that reliability is an essential characteristic for accounting information to be useful for decision making, represents the extent to which the information is unbiased, free from error, and representionally faithful (FASB 1980), and is difficult to specify precisely in accounting standards and practice. Maines and Wahlen assert that greater understanding of the empirical literature on accounting information reliability should assist standard setters and regulators in establishing financial reporting standards, preparers and auditors in implementing standards, and financial statement users in evaluating accounting information reliability.[22]

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MANAGEMENT EARNINGS FORECASTS, FINANCIAL PERFORMANCE, AND INVESTMENT DECISIONS

ALEXANDRA-MĂDĂLINA CIUTEANU

ABSTRACT. Soffer et al. examine the stock price effects of various earnings preannouncement strategies: regardless of the sign of total earnings news, the optimal disclosure strategy from a stock price perspective is to always report a positive earnings surprise. Nelson et al. observe a dependence between the flexibility in accounting standards and the type of earnings management technique employed by managers (managers tend to use operational variables when standards are precise, and accounting variables when standards are imprecise). McConnell and Servaes examine the relation between a firm's ownership structure and its performance by estimating a non-linear relation between insider stock ownership and Tobin's q.

Paton and Littleton describe accounting numbers as price-aggregates which measure the economic activities of a firm.[1] Hodge et al. find that income-increasing accounting changes, made by private firms, that move reported performance measures toward important benchmarks are viewed as strategic by investors, even when accompanied by unqualified audit opinions.[2] Ashbaugh and Pincus seek to determine whether the variation in accounting standards across national boundaries relative to IAS has an impact on financial analysts' ability to forecast non-US firms' earnings accurately.[3] Ball et al. investigate the association of legal origin and the properties of accounting earnings; using data from seven industrial countries over the period 1985–1995, Ball et al. find that earnings are more timely and conservative in common-law countries than in code-law countries (the differences emerge because firms in common-law countries operate in an environment of greater demand and supply of public disclosure, which reduces information asymmetries.[4] Soffer et al. examine the stock price effects of various earnings preannouncement strategies: regardless of the sign of total earnings news, the optimal disclosure strategy from a stock price perspective is to always report a positive earnings surprise.[5]

Nelson et al. observe a dependence between the flexibility in accounting standards and the type of earnings management technique employed by managers (managers tend to use operational variables when standards are precise, and accounting variables when standards are imprecise).[6] Salvary contends that given the capital budgeting model as the frame of reference, "recoverable cost represents a real world function – resources committed to production. It embodies the recovery process. In the absence of recovery, there is no investment. Every model of investment can be embedded in a model of recoverable cost, and recoverable cost is model consistent with respect to investment."[7] Abarbanell and Bushee examine financial analysts in relation to fundamental analysis ratios; analysts underreact to information in the signals, resulting in predictable forecast errors.[8] One CPA predicted that consulting might raise doubts related to an auditor's independence from its audit client: "On the question of maintaining independence and auditing work for a client who regularly seeks the accountant's advice upon management problems or for whom various other management services are rendered, it is probable that all doubts as to complete independence cannot be avoided."[9]

Firms with greater earnings volatility have higher costs of equity and debt capital.[10] A higher EP ratio indicates that a larger proportion of equity value is attributable to assets in place relative to growth opportunities.[11] A lower cost of capital will not only increase the present value of existing assets but will also broaden the pool of profitable investment opportunities.[12]

A firm with outstanding debt may have the incentive to reject projects that have positive net present value if the benefits from accepting the project accrue to the bondholders without also increasing shareholders' wealth.[13] The optimal amount of leverage is the amount at which the marginal agency costs of debt, which is increasing with leverage, equal the marginal agency cost of managerial discretion, which is decreasing with leverage.[14] Hegde and McDermott document a positive relation between changes in stock liquidity and index addition announcement returns, thus demonstrating that the increase in stock prices upon addition is positively related to the change in liquidity.[15]

McConnell and Servaes examine the relation between a firm's ownership structure and its performance by estimating a non-linear relation between insider stock ownership and Tobin's q.[16] Tests related to accounting discretion that do not control for performance are often mis-specified.[17] According to the Supreme Court, by certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. "The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[18]

Elgers et al. maintain that analyst forecasts at least partially reflect the differential persistence of cash flows and accruals and provide evidence consistent with the market under-weighting the information in analyst forecasts.[19] Scott views investors as attempting to predict future returns from their investments. "They seek all relevant information in this regard, not just accounting information. To maximize their competitive position as suppliers of information, accountants [...] seek to use the extent of security market response to various types of accounting information as a guide to its usefulness to investors."[20]

Burgstahler and Dichev provide several examples of firms which state that the goal of their firm is to consistently generate increasing earnings over time.[21] Hogarth and Einhorn present a model of sequential belief revision in which the response mode is predicted to have a significant effect on human judgment.[22] Hung focuses upon investor protection and legal origins, and investigates the effect of accrual accounting on the value relevance of accounting measures (earnings and return-on-equity) in an international setting; strong investor protection tends to deter managers from manipulating earnings through accruals (the negative impact of accrual accounting on the value relevance of accounting measures is weaker in countries with stronger shareholder protection).[23] Ball et al. state that common laws are adapted to contracting in open, public markets, while code laws are appropriate for contracting between a small number of parties.[24]

Burgstahler et al. examine how capital market pressures shape European private and public firm incentives to manage earnings, and observe that earnings management is more pervasive in private firms than in public firms (the influence of institutional factors on the level of earnings management extends to private firms).[25] Demski et al. analyze a setting in which entrepreneurs invest before they learn whether they will be forced to sell their assets, and study the optimal design of asset impairment regulations when the assets resale market suffers from the "lemon" problem.[26]

Aier et al. investigate whether the characteristics of chief financial officers (CFOs) are associated with accounting errors (using accounting restatements as a proxy), and study several metrics of financial literacy similar to those suggested for members of audit committees by the NYSE-NASD Blue Ribbon Committee. Aier et al. use a logit model to test whether the likelihood of an earnings restatement is related to the above metrics of financial literacy; restating and non-restating companies during the period 1997–2002 were matched on year, industry, and company size. Aier et al. find that companies whose CFOs have more work experience as CFOs, M.B.A.s, and/or CPAs are significantly less likely to restate their earnings.[27]

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AN ANALYSIS OF INVESTMENT OPPORTUNITY

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ABSTRACT. Becker-Blease and Paul investigate whether these abnormal expenditures are due to declines in information asymmetry following addition that result in enhanced access to external financing. Aggarwal and Kyaw examine how cross-border variations in institutional factors and financial development influence the role of debt in addressing agency problems and enhancing firm value for firms with different growth opportunities. Adam and Goyal define the concept of a firm's investment opportunity set, discuss the proxy variables, and their theoretical relations among each other and with the investment opportunity set, and discuss examples of investment opportunities in the mining industry.

Becker-Blease and Paul examine the relation between stock liquidity and capital investments in a sample of firms experiencing an exogenous liquidity shock, and find significant abnormal increases in capital expenditures associated with liquidity improvements, indicating that stock liquidity influences corporate investment decisions; a sample of index additions will contain firms that experienced a significant improvement in stock liquidity (such firms are well-suited because the liquidity shock is exogenous). Becker-Blease and Paul investigate whether these abnormal expenditures are due to declines in information asymmetry following addition that result in enhanced access to external financing. Becker-Blease and Paul require a control sample to properly identify abnormal changes in investment activity, as opposed to secular growth in capital expenditures; in the empirical analysis, Becker-Blease and Paul compute paired differences to benchmark each sample against its match, and measure changes following index addition by evaluating the change in the variable of interest for the one- and three-year periods following addition, compared to the year before addition (abnormal changes are defined as changes in paired differences between sample firms and their matches). Becker-Blease and Paul document overall changes in stock liquidity and capital expenditures for sample firms following their addition to the S&P 500, and investigate whether stock liquidity is related to these changes in capital expenditures by testing whether firms with the greatest improvement in liquidity also have significant increases in capital expenditures; because the analysis of changes excludes the index addition year, it is possible that Becker-Blease and Paul are picking up changes in capital expenditures that actually happen just prior to index addition.

Becker-Blease and Paul expect firms experiencing the greatest liquidity improvement to have a significant increase in capital expenditures, and expect the change in capital expenditures by these firms to be significantly higher than firms with smaller changes in liquidity. Becker-Blease and Paul interpret the evidence so far as indicative of a positive relation between stock liquidity and investment opportunities: it is possible that the increase in capital expenditures merely represents continued exploitation of growth opportunities that existed before the event of index addition, and that index firms have better access to financing pre- or post-addition, and that this access facilitates greater capital expenditures compared to matched firms. Becker-Blease and Paul check for differences in average growth in capital expenditures during three fiscal years preceding the index addition year between sample and matched firms. Becker-Blease and Paul evaluate the effect of differences between sample and control firms' pre-addition cash and leverage on subsequent capital expenditures in the regression model; it is possible that investor attention increases following index addition, resulting in reduced information asymmetry, and thus improving market conditions for external capital issues.[1]

Aggarwal and Kyaw note that debt is value-reducing for high-growth firms and it is value-enhancing for low-growth firms; using a data set with firms in twenty six countries, Aggarwal and Kyaw document that this value impact of debt holds in each country but the strength of this leverage-value relationship differs across countries with differing levels of financial development and agency costs. Aggarwal and Kyaw examine how cross-border variations in institutional factors and financial development influence the role of debt in addressing agency problems and enhancing firm value for firms with different growth opportunities. "Even though the agency conflicts between managers, outside shareholders and creditors are common in corporations throughout the world, the severity of agency problems to which investors are exposed can be expected to differ greatly across countries. There can be many reasons for such variations. One reason arises partly due to the fact that the legal protection of these investors varies internationally. The efficiency and effectiveness of corporate and other law differs across countries and so goes the level of protection against expropriation for investors – both creditors and outside shareholders. So, since countries differ in legal and institutional environments and the effectiveness of protecting investor rights, there is little doubt that optimal value enhancing financial contracting choices such as capital structure choice should also differ across countries reflecting different approaches to mitigating agency problems (depending on the institutional and contracting environment)."[2]

Aggarwal and Kyaw hold that for countries with better investor protection, the usefulness of debt in alleviating agency problems and enhancing firm value is expected to be less important; firms in countries with poor investor protection might need to hold more debt to enhance the firm value given the investment opportunity set. "As capital markets grow and develop, they generally increase in relative size so that their size as a ratio of GNP also grows. Capital market development is generally also accompanied by improved disclosure practices and regulations. Firms in countries with higher levels of capital market (both stock and bond markets) development are, therefore, likely to face less information asymmetry and likely lower agency costs. Thus, in these countries the value impact of debt may be lower. In addition, firms in countries where banks are more important sources of firm capital are also where the value relevance of debt may be lower."[3]

Adam and Goyal use a real options approach to evaluate the performance of proxy variables for a firm's investment opportunity set: on a relative scale, the market-to-book assets ratio outperforms all other proxy variables that Adam and Goyal investigate (it has the highest information content with respect to investment opportunities, and it is least affected by other factors). Adam and Goyal examine the relative performance of the most commonly used proxy variables in an industry in which firms' major investment opportunities are observable by outsiders (SEC regulations require mining firms to disclose information about the nature, quality, and magnitude of their mineral deposits). Adam and Goyal find that the market-to-book assets ratio appears to be the best proxy. "The three market-based proxies, i.e., the two market-to-book ratios and the earnings-price ratio, are strongly correlated with firms' investment opportunities. The pure accounting-based proxy, i.e., the capital expenditure over PPE ratio, also appears to be positively related to the value of investment opportunities, but this relation is not robust. Among the market-based proxies the market-to-book assets ratio has the highest information content with respect to investment opportunities.

Neither the market-to-book equity ratio nor the earnings-price ratio provides incremental information beyond that already contained in the market-to-book assets ratio. Extracting a common factor from the three market-based proxy variables does reduce some noise, but it also reduces the information content with respect to investment opportunities. This approach does not prove to be beneficial in our sample."[4]

Adam and Goyal define the concept of a firm's investment opportunity set, discuss the proxy variables, and their theoretical relations among each other and with the investment opportunity set, and discuss examples of investment opportunities in the mining industry. "The market value of equity measures the present value of all future cash flows to equity holders, from both assets in place and future investment opportunities, while the book value of equity represents the accumulated value generated from existing assets only. Therefore, the MBE ratio measures the mix of cash flows from assets in place and future investment opportunities. An empirical advantage of the MBE ratio over the MBA ratio is that its construction does not require information on the market value of debt, nor does it require the estimation of replacement value."[5] To establish which proxy has the highest relative information content, Adam and Goyal do pair-wise comparisons between real option measures and the four proxy variables, regressing the value of reserves (resources) on each proxy variable and computing a lack-of-fit measure defined as the average of the sum-of-squared residuals plus sum-of-squared prediction errors. Adam and Goyal remark that the incremental information content of each proxy is determined by regressing the value of reserves/resources on all proxy variables simultaneously, and performing a standard F-test on the null hypothesis that the slope coefficients equal zero; to measure the incremental information content of each proxy, Adam and Goyal regress the values of reserves/resources on all proxy variables. "The results show that the MBA ratio has the highest information content with respect to firms' investment opportunities relative to all other proxies. Although both the MBE and the EP ratios are related to investment opportunities, they do not contain information about investment opportunities that is not already in the MBA ratio."[6]

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FINANCIAL CONSTRAINTS, FINANCIAL CAPABILITY, AND CORPORATE POLICIES

ELENA-DOINA DASCĂLU

ABSTRACT. Chang et al. maintain that the patterns of lower investment-cash flow sensitivities and higher cash-cash flow sensitivities of financially constrained firms are necessarily interrelated because investment and the change in cash balance are two major competing uses of funds. Ahmed and Goodwin claim that there is little empirical evidence on the market's valuation of earnings restatements because of other reasons, such as accounting policy changes, and the effect of restatements on financial performance measures other than market returns. Tee et al. write that although managers consider accurate, timely and relevant information as critical to the quality of their decisions, evidence of large variations in data quality abounds.

According to Chang et al., the impact of financial constraints varies across different cash flow states: financial constraints have a small effect on corporate investment and cash policies when cash flows are positive; in contrast, the severity of constraints is high in negative cash flow years in which the cost disadvantage of external finance coincides with deteriorating operating performance; the role of financial constraints on corporate policies has been an important field of research in corporate finance (although the effect of financial constraints on corporate investment is still under debate, a recent study has drawn attention to the link between financial constraints and firms' demand for liquidity). "If financial constraints only play a marginal role in affecting corporate investment or demand for liquidity, one should not expect to observe significant differences in investment-cash flow or cash-cash flow sensitivities across firms in Australia. In contrast, Australian firms have a higher propensity to pay dividends than their US counterparts because they operate under an imputation tax system. To the extent that tax incentives influence the payment of dividends out of internally generated cash flows, the differences in US and Australian tax framework should result in disparities in the effects of financial constraints on corporate investment decisions and demand for liquidity between the two countries."[1] Chang et al. maintain that the patterns of lower investment-cash flow sensitivities and higher cash-cash flow sensitivities of financially constrained firms are necessarily interrelated because investment and the change in cash balance are two major competing uses of funds; a challenging part of examining the impact of financial constraints on corporate policies is to categorize firms according to a priori measures on financial constraints; the basic idea of multiple discriminant analysis is to utilize a set of firm-specific variables to establish a function that best distinguishes between companies in two mutually exclusive groups. "In all of our estimations of investment-cash flow and cash-cash flow sensitivities, we explicitly control for possible simultaneity biases stemming from unobserved individual heterogeneity by including fixed firm effects. Because it is possible that unspecified time effects could influence our estimations, we add year dummies to capture business-cycle influences and allow the residuals to be correlated within years using the 'sandwich' or (Huber–White) variance/covariance matrix estimator."[2]

Chang et al. empirically investigate the impact of financial constraints on cash policies by estimating cash-cash flow sensitivities, and find that under each of their three classification schemes, constrained firms show much higher cash flow sensitivity of cash than unconstrained ones; firms whose investments are constrained by capital market imperfections manage liquidity to maximize firm value. "The necessity of financially constrained firms to accumulate their buffer cash from their cash flows reduces the responsiveness of investment to cash flows. Therefore, low investment-cash flow sensitivity is associated with high cash-cash flow sensitivity for financially constrained firms. However, this mechanism can only work in good times when financially constrained firms have positive cash flows out of which they can save cash. In bad times when constrained firms incur negative cash flows, an alternative interpretation is more relevant: debt or equity financings are likely to be extremely costly for constrained firms in financial distress, characterized by negative cash flows."[3]

Ahmed and Goodwin claim that there is little empirical evidence on the market's valuation of earnings restatements because of other reasons, such as accounting policy changes, and the effect of restatements on financial performance measures other than market returns; restatements because of accounting errors are a symptom of poor earnings quality, and recent US studies document an increase in restatement frequency because of errors; extant studies using US data mostly examine restatements due to accounting irregularities and do not supplement market value tests with non-market value tests; because the histogram of independent variables showed that the data have extreme values and Ahmed and Goodwin winsorized outliers, they repeated the foregoing ordinary least squares analyses using rank regression. "Our models test long-window associations with market value and future earnings and do not speak to the information content of restatements. Unfortunately, data limitations preclude an event study design. As a result the tests might not be sufficiently powerful to consistently detect the information contained in restatements. This could explain some of the inconsistencies we report. Nevertheless, most of the models show consistent results across the various partitions. Our overall conclusion is not inconsistent with previous US research and extends research by considering restatements caused by accounting policy changes, adoption of standards and revisions in estimates."[4]

Tee et al. write that although managers consider accurate, timely and relevant information as critical to the quality of their decisions, evidence of large variations in data quality abounds; a number of data quality frameworks have been developed to organize and structure data quality dimensions; the goal of Tee et al.'s research is to identify a number of factors and test whether they affect the data quality within an organization. “Within an organizational context, if better data quality is to be achieved, it is important to understand what data quality means to that organization and also how data quality is to be measured. Based on data quality dimensions identified in prior research and on the perceptions of the participating organization this research focuses on three data quality dimensions: accuracy, timeliness and relevance. Accuracy refers to the degree of correspondence of recorded values to the actual values of the associated real-world objects. Timeliness refers to the extent to which the data are up-to-date for the required task. Relevance refers to the extent to which the data are applicable or appropriate for the required task.”[5] Tee et al. assert that data quality champions are managers who actively and vigorously promote their personal vision for using data quality-related technology innovations; the value of the products and services organizations offer often depends, in part, on the quality of the data associated with these products and services; the level of data quality associated with the products and services organizations offer is often dictated by legal or regulatory constraints; organizations often need high-quality data because of contractual obligations they have to their customers; competitive pressures drive organizations to improve the quality of the products and services they provide to customers. “The first technique used to gather data was a survey of general users and of senior managers. The survey responses were used to test the research hypotheses and as the basis of formulating questions for follow-up interviews. Measures for seven constructs were adapted from existing instruments. The remaining measures were developed by the researchers and went through extensive pretesting to ensure construct validity. All constructs except information systems/information technology capabilities were measured using multiple items. Information systems/information technology capabilities were measured by the participants' self-reported information systems/information technology experience."[6]

Atkinson et al. state that the need for financially capability has never been greater, and spell out some of the concerns that have given rise to a widespread interest in raising levels of financial capability. "Our research shows that there is a need for independent pre-purchase advice, especially for those who do not have the money to pay for a long-term relationship with a financial adviser they can trust. For people on low to middle incomes this would almost certainly need to be provided free of charge. There are some interesting developments in this area: the newly established Resolution Foundation is one example; the work being undertaken in some citizens advice bureaux is another."[7] Atkinson et al. remark that there is a clear shift in many developed countries from state to individual responsibility for ensuring income security; there has been a rapid increase in levels of borrowing to finance consumer spending in most developed economies; the OECD identified the increasing importance of access to financial services and financial inclusion at a time of increasing number and complexity of different products on offer. "The national survey was designed following the development work to fulfil a number of key features. It had to provide a sample that could represent the population of the UK, but also have samples in each country that could generate reliable results. In other words, the numbers of actual interviews in Scotland, Wales and Northern Ireland were higher than would have been achieved with a random selection."[8]

Carbo et al. write that, in Europe, the widespread process of financial deregulation has increased the range of financial services and products for certain societal groups, but it has also exacerbated for some others; financial exclusion appears to be the result of a complex, often interconnected set of factors; without a local presence and the customer knowledge that accrues from the presence by financial services firms, financial institutions may become more risk averse in their lending. "In the UK, the need to reform social security and government pressure on the banking sector via threats to mandate a universal banking service conspired to convince the banks to set up a kind of basic banking service. The key features that characterize the UK 'government as mediator' approach are promoting co-operation between the public and private sectors in tackling financial exclusion; fostering the development of credit unions; and increasing financial education and literacy of vulnerable groups; involving the British Bankers' Association and also using the extensive branch network of the Post Office."[9]

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THE EFFECTS OF FINANCIAL GLOBALIZATION AND MACROECONOMIC VOLATILITY

DAN-RADU RUŞANU

ABSTRACT. Hawkins claims that globalization has encouraged a convergence of monetary policy operating procedures in emerging market economies towards market-based instruments. Mohanty and Scatigna remark that growing global financial integration has influenced monetary policy in important ways. Andersen and Moreno state that the extent of the jure financial integration, as gauged by measures of financial liberalization, has been uneven. Mihaljek discusses why foreign exchange inflows from privatization receipts and large swings in export earnings differ from other capital inflows.

Hawkins claims that globalization has encouraged a convergence of monetary policy operating procedures in emerging market economies towards market-based instruments; the overnight rate in the bank reserves market is the most common choice, as it is usually the rate the central bank can control most easily; central banks with an interest rate target like to keep fluctuations in short-term interest rates relatively low. "In normal times central banks deal with modest shocks to the bank reserves markets, of which movements in government deposits are often the most unpredictable. However, operating procedures that work best in normal times are not necessary optimal in exceptional circumstances. Emerging economies with floating exchange rates may face what has been termed ‘sudden stops’ in capital inflows. Those with fixed exchange rates may be subject to speculative attacks. In both of these exceptional cases, the authorities may wish to drive short-term interest rates up to very high levels for a short period. The challenge is to moderate how much higher overnight rates pass through into medium-term interest rates which affect domestic economic activity.”[1] Hawkins writes that private sector debt instruments have the problem that it can be hard to distinguish credit spreads from monetary policy expectations; interest rate futures only refer to fixed expiry dates and are often illiquid for contracts beyond a few months; as domestic financial markets in emerging economies become more globalised, international factors increasingly influence them, reducing their information content; banks hold funds in accounts with the central bank, known as “bank reserves”, to facilitate settlement of transactions by bank customers or because they are required to hold reserves by the central bank. “Monetary policy generally used to be implemented through direct controls on banks. Maximum (and sometimes minimum) interest rates were set on various classes of deposits and loans, banks were required to hold (often large) proportions of their assets in government securities (or on deposit with the central bank) and limits were placed on how quickly they could expand their loan books. [...] The controls reduced the efficiency of financial markets in various ways, such as by limiting the scope for competition within the banking industry. Financial repression that keeps interest rates low may also discourage saving, or shift it from the regulated financial instrument system into other assets such as equities and real estate, or drive it offshore."[2]

Mohanty and Scatigna remark that growing global financial integration has influenced monetary policy in important ways; recent developments have shown that, while many countries have adopted more flexible exchange rate regimes, they often intervene to dampen exchange rate movements; countries have sought to limit their vulnerability to a currency crisis by choosing an appropriate exchange rate regime; currency mismatches increase the probability of a sharp fall in exchange rates, exposing banks and the corporate sectors with unhedged foreign currency liabilities to significant balance sheet losses. "To the extent that hedging and forward exchange markets have developed in many countries, exporters and firms with large foreign currency debts may be better able to protect themselves against foreign currency risks. Moreover, the hedging behaviour of firms may be regime dependent: the private sector's incentive to hedge is lower when it believes that the authorities will resist sharp changes in exchange rates."[3] Mohanty and Scatigna maintain that one instrument that countries might use to stabilize the exchange rate is the interest rate; a standard way to evaluate the role of the exchange rate in interest rate developments is to estimate the central bank's reaction function; interest rate interventions to resist currency depreciation can lead to significant long-run currency misaligments, disguising latent inflation pressures and increasing the probability of future devaluation; such interventions might increase interest rate volatility, with significant adverse implications for output. "A particular aspect of intervention is that a country's ability to resist currency depreciation is limited by its stock of foreign exchange reserves and its access to potential credit lines. Such limitations can be temporarily lowered by forward market intervention, where the central bank commits to deliver foreign exchange at a future date. However, as the experience of East Asia during the 1997–98 crises revealed, the effectiveness of such intervention against speculative currency attacks remains doubtful. It also runs the serious risk of exposing the central bank's balance sheet to any eventual devaluation. As a result, foreign exchange intervention can substitute for interest rate intervention only to a limited extent. Eventually authorities may have to consider raising interest rates."[4]

Andersen and Moreno state that the extent of the jure financial integration, as gauged by measures of financial liberalization, has been uneven; the pace of financial integration, as measured by gross capital flows, has also been uneven; net capital has flowed from poor to rich countries; in large parts of Asia, the rise in saving relative to investment has manifested itself in growing foreign exchange reserves; external shocks may dominate consumption smoothing effects; the monetary/exchange rate regime may play a role. "Spreads on emerging market sovereign bonds have fallen back to almost the levels observed before the Asian crisis, and the returns on such bonds have recently been significantly higher than those on developed country bonds. The rise in emerging market equity prices has also been spectacular as portfolio inflows have recovered substantially. Some analysts are skeptical of the sustainability of this rally. Because many emerging economies are exporters of raw materials, it is natural that their equity markets have been among the first to respond to the sharp rise in raw material prices associated with the global recovery. Moreover, experience shows that when interest rates are low in developed countries, investors are prepared to take on more risks in return for higher yields."[5] Andersen and Moreno note that it remains unclear whether financial integration has stimulated or retarded the development of domestic financial markets; with the removal of capital controls, large emerging market companies with high ratings are covering their external financial needs by issuing bonds in the international market or listing in New York or other advanced equity markets. "There are signs that 'deeper' developments have taken place which, on balance, might reduce the volatility of capital flows and the vulnerability of emerging economies to external shocks. Four important trends can be identified: reduced vulnerability to shocks, including lower currency mismatches; increased use of market-based instruments; deepening of domestic financial markets; and greater discrimination on the part of investors."[6]

Mihaljek discusses why foreign exchange inflows from privatization receipts and large swings in export earnings differ from other capital inflows, and why conventional monetary policy tools may not be fully effective in dealing with such inflows. Mihaljek reviews experience with the use of, respectively, special privatization accounts and export earnings stabilization funds; how a country manages revenues from exports of its key resources has major implications for its macroeconomic stability and economic development. "The monetary consequences of privatization-related inflows are similar to those of other capital inflows. In particular, privatizations to non-residents tend to have an expansionary effect on monetary aggregates because of the associated inflows of foreign exchange. Privatisations to residents have a more ambiguous effect because they usually represent an exchange of a resident's domestic financial assets for the state's real assets. Any expansionary effect in such circumstances would depend on how the government spends the proceeds, how the residents finance the purchase of state assets, and whether the new owners make additional investments in firms they acquire, and how these investments are financed."[7] Mihaljek asserts that conventional sterilization methods are likely to be less effective or have undesirable consequences if applied to very large and unpredictable shocks to liquidity; even when a large part of the inflows accrue to the government and government deposits are held with the central bank, the central bank still needs to agree with the government on measures that will smooth the withdrawal of deposited funds; many emerging market economies have channeled at least part of the receipts from the sale of state assets through special privatization accounts set up at the central bank or other government agencies. "Large and volatile revenue streams from exports of oil, non-oil commodities and other specialized goods and services can create a number of complications for domestic monetary policy. During upturns, such exports generate shocks that can affect the exchange rate through disposable income and wealth effects, through procyclical government spending on non-tradables, or through capital inflows. During downturns, countries with heavy reliance on volatile export revenues may have substantial financial needs. International lending to such countries, however, tends to be procyclical. Countries may therefore place a premium on liquidity and may wish to hold a large stock of liquid financial assets to avoid passing on the shock to the domestic private sector. But this has the disadvantage of complicating domestic monetary policy."[8]

Mihaljek claims that evaluation of country experiences suggests that export earnings stabilization funds have been associated with a variety of operating rules and monetary and fiscal policy experience. "In several cases, rules have been bypassed or changed, and additional rules, such as compulsory foreign exchange surrender requirements, have had to be used to constrain the impact of volatile export revenues on the exchange rate and money markets. Regarding the political economy arguments for such funds, the key problem seems to have been the absence of transparent rules free from political interference, as well as of regular and frequent disclosure of the operations of the funds. The main lesson thus seems to be that export earnings stabilization funds should not be seen as a simple solution to a complex problem."[9]

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QUALITATIVE RESEARCH METHODS IN MARKETING

AURELIAN A. BONDREA

ABSTRACT. Gummesson contends that quantitative techniques are mostly used to try to pinpoint causality, usually between two or a few variables where the independent and dependent variables are defined. According to Milliken, in reviewing the management literature, especially marketing management, it is evident that little attention has been paid to qualitative research in the discipline. Varki et al. hold that, in marketing, qualitative data are used in theory development for investigating marketing phenomena in more depth. Whitehead claims that organizations achieve success by building strong, loyal and enduring relationships with their customers.

Gummesson notes that marketing is an established discipline in business schools and an established function in enterprises, "where, at best it is part of the corporate culture, at worst it is encapsulated in its own silo. [...] Marketing situations are not easy to grasp. It should be unnecessary to say that marketing decisions and actions are not just based on analyses of data, because data are mostly hard to find, hard to define, and they are incomplete."[1] Gummesson contends that quantitative techniques are mostly used to try to pinpoint causality, usually between two or a few variables where the independent and dependent variables are defined; qualitative research is characterized by data collection, analysis and interpretation in part taking place simultaneously, and tentative conclusions being drawn during fieldwork and the reading of archival records. “Researchers in marketing should be more critical to data and their sources, but in a constructive spirit. Newspapers and gossip are unreliable sources that need to be double-checked, we are aware of that. It seems to be less understood that official statistics can be a pack of lies, defined for a specific political or business purpose and compiled under a series of assumptions that are not known to the user of the statistics. Interviews with CEOs, marketing directors, consultants and politicians are often misleading, as they are speaking for their sake.”[2]

Gummesson maintains that theory generation is more often the outcome of a conceptual and qualitative process, whereas theory testing is more associated with empirical, quantitative hypotheses testing; researchers in marketing seem to settle for theory on a low level of abstraction or generality and have difficulties seeing the broader, systemic context; researchers seem to get stuck in the middle, neither being firmly based in real world data, nor reaching a sufficient level of abstraction; researchers are also stuck in the past and an unwarranted notion that theory advancement is a cumulative process. “For the purpose of illustration, the general framework is clad in my own research in marketing, where the heavy parts are marketing management with services marketing and relationship marketing/CRM at its core, and with input from other relevant research. It starts with service research based on data from different service areas. The data are categorized and conceptualized, forming the beginnings of specific theories: a theory for the marketing of professional services, another for e-services, and so on. These theories in turn are merged into a general theory of services marketing, which later becomes one of several inputs to a theory of relationship marketing/CRM. This is en route to a general theory of marketing and a theory of management. However, the journey as such may be the significant result as long as the journey is guided by vision and commitment."[3]

According to Milliken, in reviewing the management literature, especially marketing management, it is evident that little attention has been paid to qualitative research in the discipline (this is perhaps due to the propensity to apply quantitative approaches in an attempt to establish the credibility of a relatively young subject); to neglect qualitative research methods in marketing can stifle innovation, creativity and new ways of thinking that are the very essence of successful marketing.[4] Noble contends that social marketing is a method of communicating key messages to selected audiences using multiple communication strategies to guide people through a behaviour change process; while tax is perceived as generally necessary in principle, it is strongly disliked (the tax system in New Zealand is seen as inherently unfair by both small to medium businesses and wage earners interviewed); business focused (non-evaders) who do not engage in tax evasion due to their long or short term business or lifestyle goal of either making a success of the business or enjoying lifestyle of the business. Milliken argues that tax advisors and accountants say they would openly discourage evasion and even force taxpayers to go to another accountant if they continued to push tax evasion (none could remember it ever happening).[5]

Varki et al. hold that, in marketing, qualitative data are used in theory development for investigating marketing phenomena in more depth; percentage agreement is currently the most popular method among marketers for assessing the quality of categorization employed. Varki et al. develop the fuzzy latent class model (FLCM), which provides the researcher with estimates of (1) the proportions of fuzzy and crisp items, (2) the proportions of crisp items in each category, (3) the mixture distribution of the fuzzy items, and (4) the probabilities with which judges classify and type of item to each category. Varki et al. state that the FLCM model provides an estimate of the proportion of fuzzy items, and this serves as one direct measure of data fuzziness; in FLCM, Varki et al. allow for the possibility that different judges may classify the same item as if it were from different categories because of the mixed nature (fuzziness) of the item, and therefore the cross-product moments are not generally zero. "Because most customers described some type of service failure, we classified responses into three categories: basic service failure; service encounter failure; and other, a category for all other responses. The basic service failure category includes core service failures (e.g., billing errors, service catastrophes) and poor responses to service failures; service encounter failure includes impolite, uncaring, and unresponsive customer service provider interactions; and other includes inconvenience, involuntary switching, and so forth."[6]

Varki et al. assert that, in marketing, qualitative data are common in the descriptions of complex market stimuli or phenomena and often are found in the form of open-ended responses to survey questions and in behavioral experiments; it is important to model data fuzziness in marketing applications, which requires specific analytical tools; Varki et al.'s model can improve the diagnostic value of judgment-based classifications by distinguishing between misclassification error and inherent item fuzziness. "The drawbacks of percentage agreement, and many other methods that summarize reliability as a single statistic, are that they (1) do not correct for chance agreements, which can be quite substantial; (2) do not provide information on whether interjudge reliability is low because of judges' lack of expertise or because of ill-defined categories; and (3) do not provide sufficient diagnostic detail to help researchers improve the categorization scheme. Thus, when interjudge reliability is low, these methods do not provide the researcher with guidance on how to train the judges better, nor do they even indicate whether the true character of the items is accurately summarized in the selected classification scheme."[7]

Varki et al. develop their model (FLCM) and a measure of the fuzziness level of the data set, show how it can be obtained from FLCM estimates (this measure and the estimated proportion of fuzzy items, which are also provided by FLCM, both provide ways of testing whether a data set is significantly fuzzy), test FLCM on marketing data, and compare the results with those of LCM. Varki et al. report the LCM and the FLCM estimates of the classification probabilities of each judge for the crisp items in the data set. Varki et al.'s model enables researchers to assess both the classification accuracy of the judges (or instruments) employed and the quality of the categorization framework in terms of its ability to provide crisp classifications; FLCM can accommodate binary categories that partition an underlying continuum into extremes. "Researchers may be interested in evaluating the managers' abilities to spot the right kind of applicant. Other business scenarios include the classification of business prospects/clients by advertising managers in terms of client–agency fit and the identification of potential defaulters by credit managers. The maximum likelihood estimations provided by FLCM are only as good as the data used to estimate them, and to that extent, it is important that researchers sample the content domain in an adequate and appropriate manner. However, unlike percentage agreement, which is not model-based, FLCM still provides an assessment of the accuracy of the estimates (through estimated standard errors) and the quality of fit (through LR tests and model selection criteria)."[8]

Whitehead claims that organizations achieve success by building strong, loyal and enduring relationships with their customers; marketing research helps determine how the organization can best perform the set of activities that will satisfy customers' needs; advertising articulates marketing strategy and communicates product benefits; in combination with quantitative research methodologies, qualitative research can be especially powerful. "Qualitative research generates customer insights that enhance the organization's understanding of purchase motivations and the purchase decision-making process, as well as how a product or service is actually used, what needs it satisfies and how it is valued relative to competitive offerings. Qualitative research assists in the investigation of product/service positioning and image (or the comparative positioning and image of competitive products/services), and by determining how customers' needs are changing (or how they can be better satisfied), qualitative research can provide critical customer input into the new product development process."[9] Whitehead claims that the challenge is to transform the information and insights gathered through qualitative marketing research into marketing strategy that will lead to a unique and meaningful positioning that resonates with customers. "In today's intensely competitive environment, we need to be building, nurturing and growing our relationships with our customers on an ongoing basis, by knowing our customers, understanding their needs, and developing the programs and services that meet those needs. And we need to be doing it better than our competitors do! Only by building strong, long-term relationships with our customers can we survive and thrive."[10]

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ACCOUNTING DISCRETION AND EARNINGS MANAGEMENT

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ABSTRACT. Bowen et al. examine the cross-sectional relation between an aggregate index of accounting discretion and governance quality after controlling for other economic determinants of accounting discretion such as firm size, leverage, growth opportunities, risk, performance and stakeholder claims. Tan and Jamal conduct an experiment in which opportunistic and value-maximizing managers are given different levels of accounting discretion to report smooth increasing earnings over time.

Managers, in general, exercise accounting discretion in an efficient manner consistent with long run shareholder value maximization.[1] Managers use accounting discretion to avoid reporting negative earnings surprises.[2] Capalbo writes that in countries where the use of financial statements is minimal and relative accounting debate less intense, domestic practices may gain benefit from being consistently applied. The Italian financial system is credit-based: while banks play a predominant role, the financial industry itself enjoys significant autonomy in setting its accounting standards (this is especially so in respect of the accounting for the cost of pensions as savings banks have offered the most significant and almost unique example of employees' defined benefit pension plans in Italy).[3] A value-maximizing manager uses accounting discretion to communicate private information about future earnings and their variability to shareholders.[4] It is difficult for managers to make direct disclosures of private information to shareholders in view of the existence of proprietary costs of disclosure, institutional and legal constraints.[5] Zhang and Zhang investigate the factors affecting acquirers' allocation of purchase price between goodwill and identifiable intangible assets with finite lives; SFAS 142 replaces goodwill amortization with periodic impairment tests that are based on fair value estimates, while most identifiable assets are still amortized over finite useful lives. Management is motivated to allocate more purchase price to goodwill when 1) they benefit from reducing amortization expenses or maintaining a strong balance sheet, and 2) they are capable of avoiding future goodwill impairment losses by managing the fair value estimate of goodwill.[6]

Bowen et al. extend the prior literature and find a link between poor governance and managers' accounting discretion; however, Bowen et al. fail to detect a negative association between accounting discretion attributable to poor governance and subsequent firm performance (managers do not abuse accounting discretion at the expense of firms' shareholders). Bowen et al. examine the cross-sectional relation between an aggregate index of accounting discretion and governance quality after controlling for other economic determinants of accounting discretion such as firm size, leverage, growth opportunities, risk, performance and stakeholder claims. Documenting an association between weak governance structures and accounting discretion per se need not necessarily imply managerial opportunism as such association can also occur for efficiency reasons. Bowen et al. discuss the framework underlying our empirical tests, introduce the three individual measures and the one combined index of accounting discretion, discuss the economic determinants and governance variables hypothesized to explain accounting discretion, and provide empirical results on (i) the relation between governance quality and accounting discretion; and (ii) the empirical analysis that attempts to discriminate between efficiency and opportunism as competing explanations for accounting discretion. While changes in economic conditions can trigger re-contracting, contracting parties naturally price-protect against any expected managerial opportunism. The firm-value-maximizing level of expected managerial opportunism occurs when the marginal cost of monitoring the manager is equal to the marginal benefit from reducing expected managerial opportunism. Discretion due to poor governance is positively associated with future operating cash flows: shareholders may benefit from earnings management, perhaps because it signals future performance.[7] The market severely penalizes growth firms for negative earnings surprises; growth firms have incentives to meet earnings benchmarks, perhaps to avoid increases in the cost of capital or to maintain access to capital.[8] Managerial ownership is related to lower levels of accounting accrual adjustments.[9] Managers have incentives to smooth earnings volatility as cash based incentive pay tends to increase with earnings persistence.[10] Beatty and Weber examine Statement of Financial Accounting Standards 142 adoption decisions, focusing on the trade-off between recording certain current goodwill impairment charges below the line and uncertain future impairment charges included in income from continuing operations, and investigate several potentially important economic incentives that firms face when making this accounting choice.[11] McLelland examines the relationship between accounting discretion and investment opportunity sets (IOSs) of regulated banks in the presence of accounting-based regulatory contracts; the proposition that accounting discretion allows a bank to avoid constraints on its IOS resulting from risk-based regulatory capital requirements is examined. McLelland explores the conditions under which accounting discretion can influence a bank's IOS and results suggest that, in general, accounting discretion has no effect on a bank's IOS, or on compliance with regulatory capital requirements, independent of its effect on dividends or other financing transactions.[12]

Bowen et al. show that firms that have more ongoing implicit claims with stakeholders such as employees, suppliers and customers choose relatively aggressive accounting to influence stakeholders' assessments of the firm's reputation.[13] Larger firms face more political costs and hence have incentives to exercise accounting discretion to reduce unwanted political visibility.[14] Value-maximizing managers smooth earnings to communicate their firm's value to shareholders; when accounting discretion is available, opportunistic managers are able to mimic the earnings patterns reported by value-maximizing managers. Tan and Jamal report an experiment that investigates (1) whether a reduction in accounting discretion leads to a separation in earnings series reported by opportunistic and value-maximizing managers, and (2) whether a reduction in accounting discretion impedes the ability of value-maximizing managers to communicate smooth increasing earnings to shareholders when operational smoothing variables are available. Tan and Jamal's study complements archival research on earnings management by using an experimental approach to examine the effect of a reduction in accounting discretion on the ability of managers to manage earnings for value-maximizing and opportunistic reasons. Tan and Jamal conduct an experiment in which opportunistic and value-maximizing managers are given different levels of accounting discretion to report smooth increasing earnings over time. If managers were required to smooth earnings only, without regard to the level of earnings, a manager who smoothed a series of losses would be ranked equally with one who smoothed a series of positive earnings. A restriction in accounting discretion is effective in bringing about a separation in the earnings series reported by low and high foresight managers (at low levels of accounting discretion, low foresight managers are unable to report smooth increasing earnings). For a reduction in accounting discretion to be an effective separating mechanism, it has to prevent opportunistic reporting of earnings by low foresight managers, but at the same time allow high foresight managers to continue reporting smooth increasing earnings. When accounting standards are precise, auditors generally accept actions by managers to structure transactions in a way that avoids an infringement of accounting rules; when accounting standards are less precise, auditors prefer managers not to structure transactions. When accounting discretion is reduced, high foresight managers are likely to organize their investments in a way that reduces their exposure to the variability in earnings; a reduction in accounting discretion will not affect their ability to report smooth increasing earnings over time (low foresight managers lack the foresight to utilize operational variables effectively). Accounting decisions, which relate to adjustments to accounting provisions, are made at the end of the period after actual operating earnings from operating decisions are known (participants are assigned different levels of accounting discretion for adjusting provisions).[15]

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ACCOUNTING'S EFFECTS ON MANAGERIAL BEHAVIOR

ION ŞUIU

ABSTRACT. Bonner et al. present an extensive review of laboratory studies on financial incentives and examine the relations between type of task and type of incentive scheme, respectively, and task performance. Davila and Foster examine the association between the time-to-adoption of operating budgets and company performance, and find a significant increase in the number of employees of the company around the adoption of operating budgets (faster adoption of operating budgets is associated with faster growing companies).

Bonner et al. remark that management accounting information plays an important role in motivating individuals to improve performance; this role tends to be operationalized by linking compensation to performance, typically through the provision of financial incentives. A large body of empirical evidence indicates that financial incentives frequently do not lead to increased performance: it is important to examine variables that may interact with financial incentives in affecting task performance. Bonner et al. present an extensive review of laboratory studies on financial incentives and examine the relations between type of task and type of incentive scheme, respectively, and task performance.[1] Davila and Foster investigate the effect of hiring a financial manager as an endogenous variable; in the first stage of a two-stage model, Davila and Foster find that CEO experience, the presence of venture capital funds, CEO beliefs about management accounting systems, and number of employees are associated with cross-sectional variation in this hiring decision. When treating this decision as endogenous, time-to-hiring a financial manager is unrelated to operating budget adoption.[2] The intangible assets management has a voluntary (unregulated) choice to record identifiable intangible assets that are more highly correlated with underlying economic factors than the regulated classes, purchased goodwill and R&D assets; limiting management's choices to record intangible assets tends to reduce, rather than improve, the quality of the balance sheet and investors' information set.[3] Frederickson et al. report the results of an experiment that examines how relatively sophisticated financial statement users interpret management stock option compensation disclosures under SFAS No. 123 and SFAS No. 123R. Frederickson et al. predict and find that mandated income statement recognition, as required under SFAS No. 123R, leads to higher user assessments of reliability than either voluntary income statement recognition or voluntary footnote disclosure, options allowed under SFAS No. 123. Frederickson et al. examine the amount users invest in response to these accounting treatments, and find that users invest more in a firm when management chooses income statement recognition than when management chooses footnote disclosure. Frederickson et al. find no difference in investment amounts between mandated recognition and either voluntary recognition or footnote disclosure; in side-by-side comparisons, where one firm disavows and the other does not, disavowals may affect user judgments and decisions.[4]

Davila and Foster examine the association between the time-to-adoption of operating budgets and company performance, and find a significant increase in the number of employees of the company around the adoption of operating budgets (faster adoption of operating budgets is associated with faster growing companies). Davila and Foster extend the findings to additional management accounting systems including: cash budgets, variance analysis, operating expense approval policies, capital expenditure approval policies, product profitability, customer profitability, and customer acquisition costs.[5] Way examines the extent to which management makes accounting choices to record intangible assets based on their insights into the underlying economics of their firm. Wya's study exploits a setting in which management has accounting discretion to record a wide range of intangible assets. Management's choice to record intangible assets is associated with the strength of the technology affecting the firms operations, the length of the technology cycle time, and property rights-related factors that affect the firm's ability to appropriate the investment benefits. These effects are more important than other contracting and signaling factors consistent with the underlying economics operating as a first-order effect as envisaged by GAAP.[6] Watts examines alternative explanations for conservatism in accounting and their implications for accounting regulators (SEC and FASB), and summarizes the empirical evidence on the existence of conservatism, conservatism's increase over time, and conservatism's alternative explanations. Two non-conservatism explanations (earnings management and the abandonment option) cannot individually or jointly explain the observed systematic understatement of net assets that is the hallmark of conservatism; assessing the relevance of an accounting method to financial statement users' decisions requires assessing managers' abilities to use that method to manipulate accounting numbers and commit fraud.[7] The SEC issued Staff Accounting Bulletin (SAB) No. 101 to address its concern that firms were masking true performance by managing earnings using accelerated revenue recognition. Altamuro et al. use a sample of firms that accelerated revenue recognition prior to SAB No. 101 adoption (SAB 101 firms) and a matched set of firms that were unaffected by this regulation (unaffected firms). SAB 101 firms are more likely to meet earnings benchmarks: in the pre-adoption period, SAB 101 firms report fewer small negative and more small positive earnings than they do in the post-adoption period and than do unaffected firms in the pre-adoption period (SAB 101 firms report fewer small negative and more small positive earnings changes in the pre-adoption period compared to the post-adoption period).[8]

Desai et al. investigate the reputational penalties to managers of firms announcing earnings restatements, examining management turnover and the subsequent employment of displaced managers at firms announcing earnings restatements during 1997 or 1998. 60 percent of restating firms experience a turnover of at least one top manager within 24 months of the restatement compared to 35 percent among age-, size-, and industry-matched firms. The subsequent employment prospects of the displaced managers of restatement firms are poorer than those of the displaced managers of control firms; both corporate boards and the external labor market impose significant penalties on managers for violating GAAP. Private penalties for GAAP violations are severe and may serve as partial substitutes for public enforcement of GAAP violations.[9] Bonner et al. posit that performance in tasks of varying types is differentially sensitive to the increases in effort induced by financial incentives and that not all incentive schemes elicit the same level of effort; incentives improve performance in only about one half of the experiments. As tasks become more cognitively complex, and thus as the average subject's skill level decreases, it is less likely that incentives improve performance. Quota schemes have the highest likelihood of evincing positive incentive effects, followed by piece-rate schemes, tournament schemes, and fixed-rate schemes. The type of task being performed and the type of incentive scheme being employed affect the efficacy of financial incentives and may influence the design of management accounting and control systems.[10] Botosan et al. summarize conceptual issues that arise in the definition, recognition, derecognition, classification, and measurement of liabilities, highlight problems in existing accounting standards for liabilities and identify opportunities to refine those standards, and describe evidence from empirical accounting research involving liabilities, identifying opportunities for future research. Botosan et al. outline the inconsistencies and controversies surrounding existing accounting standards for liabilities, describing the research evidence that provides insights into accounting for liabilities.[11] Howard and D'Antonio show that traditional short hedgers often face a cost in the form of a positive derivative risk premium; the hedge ratio chosen should be significantly less than the traditional risk minimum hedge ratio since marginal cost rises dramatically as the risk minimum position is approached. Howard and D'Antonio present a modified hedge ratio and hedge effectiveness measures to replace the commonly used risk minimum equivalents; the use of these alternative measures is permissible under SFAS No. 133 and IAS No. 39 and leads to improved hedging decisions.[12] When accounting standards allow for discretion, opportunistic managers can report smooth earnings, and this makes it difficult for investors to discern a firm's value from earnings patterns.[13] Soffer et al. examine a sample of firms with earnings preannouncements to determine the most prevalent earnings disclosure strategy that managers follow and the corresponding stock price effects; controlling for total earnings news, firms with negative earnings surprises experience equity returns that are significantly more negative than firms with positive or zero earnings surprises.[14]

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MONETARY POLICY RULES AND MACROECONOMIC PERFORMANCE

CRISTIAN GRĂDINARU

ABSTRACT. Goodfriend and Prasad asserts that the fraction of reserves sterilized by the central bank has varied over the last few years, and it is not even straightforward to assess exactly how much sterilization has taken place. Gerlach and Gerlach-Kristen contend that the Hong Kong Monetary Authority (HKMA) and the Monetary Authority of Singapore (MAS) have been strikingly successful in delivering on their monetary policy objectives. Bhattacharya says that the most important part of the monetary policy framework in a country is the task mandated to the monetary authorities; the relative emphasis on price stability versus growth is subject to interpretation. Ito reviews Japanese monetary policy from 1998 to the present.

Goodfriend and Prasad review developments in the exchange rate and capital control regimes (having an independent monetary policy is desirable for this policy tool to be effective), discuss the direction in which the monetary policy framework should be developed, and argue that there may be merit to using a low inflation objective as the nominal anchor; given the nature of the regime and a number of institutional constraints, the foreign exchange markets have remained relatively thin and underdeveloped. "In recent years, bank financing has accounted for more than four fifths of total funding provided through the formal financial sector. Stock market capitalization amounts to only about 30% of GDP. With only a small number of enterprises permitted to list and about two thirds of shares in listed enterprises held by the state and not traded, the stock market does not play a major role in intermediating household saving into corporate investment. Efforts to reduce the overhang of non-trades shares have depressed stock prices indexes, which have declined since 2000, notwithstanding the strong performance of the economy. The bond market is small and dominated by treasury and financial bonds, with corporate bonds barely on the radar screen. Thus, the banking system is crucial to the monetary policy transmission mechanism, even more so in China than in other countries that may have more balanced financial market development."[1] Goodfriend and Prasad asserts that the fraction of reserves sterilized by the central bank has varied over the last few years, and it is not even straightforward to assess exactly how much sterilization has taken place; a continuation of monetary policy geared to maintaining a tightly managed foreign exchange rate as the nominal anchor carries substantial risks; state enterprises that do make profits are generally not required to pay dividends to the state (so they can use retained earnings to finance requirements for working capital and new investments); making low inflation the main objective of monetary policy is the most reliable way to enable the PBC to stabilize domestic inflation and employment against macroeconomic shocks. "China has already taken a number of steps to modernize its banking system, but much remains to be done. The question is how much more modernization is needed to support independent monetary policy. China has already created some of the institutional flexibility necessary for the PBC to transmit monetary policy actions effectively to aggregate demand – through a liquid bank reserves market, and with fully flexible, competitively determined interbank interest rate. China has allowed deposit and lending rates to be more responsive to the interbank rate; although there continues to be a ceiling on deposit rates and a floor on lending rates. A relaxation of these remaining rate restrictions would help complete the monetary policy transmission mechanism."[2]

Gerlach and Gerlach-Kristen contend that the Hong Kong Monetary Authority (HKMA) and the Monetary Authority of Singapore (MAS) have been strikingly successful in delivering on their monetary policy objectives. Gerlach and Gerlach-Kristen provide an overview of the structure of the Hong Kong and Singapore economies, argue that while there are some differences, these are not significant, study macroeconomic outcomes since the early 1980s, and find that the difference in the monetary policy regimes is reflected in the behaviour of nominal variables. The economies of Hong Kong and Singapore are similar in important ways: they are extremely small, highly open to international trade and very advanced. Gerlach and Gerlach-Kristen write that manufacturing is more important in Singapore than in Hong Kong;

both economies trade intensively with their immediate neighbours, mainland China and Malaysia, respectively. "Singapore's monetary history is in many ways similar to that of Hong Kong. From the 1930s, Singapore's currency was pegged to sterling. The devaluation of sterling in 1972 led the monetary arrangements in Singapore to be changed to a peg to the USD, which in turn was abandoned in 1973 following the breakdown of the Bretton Woods system. With the exchange rate floating, monetary policy was aimed at limiting inflation, and was conducted using a range of intermediate targets and direct controls. In the early 1980s, the MAS adopted the current framework in which the inflation objective is pursued by managing the exchange rate."[3] Gerlach and Gerlach-Kristen plot short- and long-term interest rates in the two economies: because of the currency board, short-term rates in Hong Kong are largely determined by USD interest rates, except during periods of speculative outflows when rates rise to compensate for the perceived exchange rate risk; inflation in Hong Kong was on average higher than in Singapore when a real appreciation of the two currencies was warranted; Hong Kong experienced deflation following the Asian financial crisis. "The MAS manages the effective exchange rate in response to economic developments, implying that shocks to inflation are less persistent in Singapore than in Hong Kong. [...] A rise in the output gap raises inflation in both economies and an appreciation of the

REER (which is defined such that an appreciation is an increase) reduces inflation."[4]

Bhattacharya says that the most important part of the monetary policy framework in a country is the task mandated to the monetary authorities; the relative emphasis on price stability versus growth is subject to interpretation; the administered interest rate structure, the absence of significant innovations in the financial sector and the lack of large cross-border capital flows ruled out large shocks in the financial sector relative to the real sector. "India adopted the multiple indicator framework. The possible other candidates were exchange rate targeting, interest rate targeting and IT. In the Indian context, exchange rate targeting was not appropriate due to the relatively closed nature and large size of the economy. Similarly, stickiness in long-term rates was a major impediment to considering an interest rate targeting framework seriously. IT, in contrast, was a serious option. It is, therefore, relevant to discuss why India did not adopt IT at that time."[5] Bhattacharya notes that since the adoption of the MIA, there have been four major changes: the first is related to the signaling aspect of monetary policy; the second change was in evolution of policy coordination (culminating in the Fiscal Responsibility and Budget Management Legislation); the third change was in clearer demarcation of stabilization policies from structural policies; the fourth change was the result of the changed approach regarding the second and the third (it concerned the way these long-run structural aspects were handled). "Among the four traditional channels of monetary policy transmission, common sense suggests that the exchange rate channel and the asset prices channel would play a limited role in India. The role of the exchange rate channel is limited because of India's relatively closed nature. Though the degree of openness of the Indian economy has increased substantially compared to the 1980s, the large size of the domestic market compared to total exports or imports suggests that the exchange rate channel may not be an influential channel. So far as the asset price channel is concerned, compared to the developed economies, the financial system in India has a relatively low vulnerability to asset bubbles."[6]

Ito contends that the adoption of an inflation targeting framework with decisive actions may influence inflation expectations, and that there are several arguments opposing the inflation targeting framework: (i) credibility would be lost, rather than built, if inflation targeting was announced when there was no instrument to get out of deflation; (ii) inflation targeting would not influence inflation expectations, since these are backward-looking; (iii) some regarded inflation targeting as a way to increase the inflation rate no matter what, in order to help debtors in the economy – large indebted corporations and the national government with large fiscal debts; (iv) if inflation targeting was credible, then the long-term interest rate would go up immediately and that would be bad for the economy. "The Bank of Japan rejects the interpretation that the March 2001 condition was inflation targeting or that the October 2003 clarification was a form of inflation targeting. Objectively speaking, these numerical conditions were steps towards inflation targeting. However, important ingredients were still missing if they were to be interpreted as an inflation targeting framework. The ceiling was not announced, as zero percent seems to be a floor. The framework was only an exit condition, and not a permanent framework. The commitment to overcome the deflationary state was less clear, as the horizon and instruments to achieve the exit conditions were not clarified. The conditions read like a set of circumstances that the Bank of Japan would sit and wait for rather than something the Bank intended to achieve. For these reasons, it is far-fetched to interpret these conditions as constituting inflation targeting."[7] Ito reviews Japanese monetary policy from 1998 to the present; the beginning year of analysis was set at 1998 because it was the year the Bank of Japan gained legal independence. "The Bank, having become legally independent in March 1998, aimed at stimulating the economy, ending deflation and stabilizing the financial system. The availability and effectiveness of traditional policy instruments was severely constrained as the policy interest rate was already virtually at zero, and the nominal interest rate could not become negative (the zero bound problem). Worsening deflation means that the real interest rate (the nominal interest rate minus the inflation rate) has to rise. Therefore a deteriorating economy, putting pressure to lower prices, would reinforce itself by increasing the real interest rate."[8]

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INTERNATIONAL TRADE AND ECONOMIC DEVELOPMENT

LILIANA CRĂCIUN

ABSTRACT. Kandil examines channels of interaction between exchange rate shifts and the macroeconomy. Exchange rate shifts are differentiated into anticipated and unanticipated components. Goldin and Reinert consider the development benefits and costs of four kinds of capital flows: foreign direct investment, equity portfolio investment, bond fi- nance, and commercial bank lending. Kandil and Mirzaie examine determinants of private consumption in a sample of developing countries.

Dichter claims that the private sector can and is being more effective at economic development "than we development professionals have been. Whatever we may not like about the excesses of capitalism, the private sector will over time give the poor what *they* want, which is first and foremost increased spending power and the means to get it. The poor themselves are on to us. In this globalized world, poor people everywhere have leapfrogged ahead of the development assistance industry. Millions of poor have shown that they will no longer wait around for us. For good or bad, illegal or not, they are on the move. And while those with the energy and courage to move are in the minority, the signs are that the leverage they represent (both through their example and their remittances) has unprecedented power for change. That is real people power."[1] The ultimate hubris is to try to engineer change from outside a dynamic living system "composed of different interests, passions, and affinities, all bubbling up out of a soup containing an intricate social and political structure that itself sits on top of years of history, not to mention a particular geography, climate, and set of natural endowments."[2]

Ripoll uses a two-sector general equilibrium model to analyse both steady-state and stochastic dynamic effects of two real exchange rate targeting policies: a constant-target, and a band-target rule. In the model, targeting is implemented by imposing a stochastic fully-rebatable tax on the consumption of non-traded goods. When comparing only steady states, a real exchange rate appreciation favours labour and capital in the non-traded sector, while factors in the traded sector are favoured by depreciations; both rules reduce the volatility of investment and the trade balance; in the stochastic economy sectoral income distribution outcomes depend on the design of the constant and band-target rules. In particular, a variety of outcomes may be generated depending on the magnitude of the constant target, or the amplitude of the band, relative to the volatility of productivity shocks.[3] Kandil examines channels of interaction between exchange rate shifts and the macroeconomy. Exchange rate shifts are differentiated into anticipated and unanticipated components. Each component affects the demand and supply sides of the economy. Exchange rate shifts determine export competitiveness and the cost of imported inputs (the evidence reveals a relatively more important role for the cost channel in determining the real and inflationary effects in developing countries, compared with developed countries); currency appreciation (depreciation), both anticipated and unanticipated, results in an increase (decrease) in output growth and a reduction (an increase) in price inflation in many developing countries (this evidence indicates the adverse effects of currency depreciation on macroeconomic performance in developing countries).[4] Goldin and Reinert considers the development benefits and costs of four kinds of capital flows: foreign direct investment, equity portfolio investment, bond finance, and commercial bank lending. The development impacts of these flows are conditional on both their specific characteristics and the larger policy environments in which they take place; the survey claims short-term superiority for foreign direct recommendations to make capital flows more development-friendly.[5] Using a dual structure depicting a developing economy, Chao et al. show that increased partial privatization or foreign competition can lead to wage inequality between skilled and unskilled labor; rising wage inequality can be triggered by inflows of unskilled labor or outflows of skilled labor and/or capital. Partial privatization or foreign competition reduces the urban output, thereby raising the goods price and unemployment ratio. These effects lower social welfare of the economy.[6]

Mandle holds that the advocates of localism leave unanswered how income standards might rise in a world in which economic development is rejected and flows of capital, resources, and knowledge are impeded.[7] Modern economic growth is desirable, and policies and institutions impeding that process should be opposed.[8] Globalization has three legs: the availability of new technologies, a liberal international trading system, and a well-educated labor force. “What is needed is a policy agenda that both preserves the development-promoting aspects of the process and, at the same time, reduces the damage the process inflicts on innocent victims.”[9] Kandil and Mirzaie examine determinants of private consumption in a sample of developing countries; the empirical model includes income, a proxy for the cost of consumption, and the exchange rate. Anticipated movements in these determinants are likely to trigger adjustment in planned consumption, while unanticipated changes determine random transitory adjustment in consumption. Monetary growth stimulates an increase in private consumption; this evidence supports recent calls to decrease the size of government and enhance the role of monetary policy in stimulating private activity in developing countries.[10] Devadoss notes that the developing countries’ economies are characterized by heavy dependence on farm sector, labor-intensive agriculture, and persistent unemployment: rich nations’ unfair agricultural policies are detrimental to the well-being of poor exporting countries. Devadoss develops a model incorporating developed countries’ domestic and trade policies and developing countries’ economic characteristics to illustrate the adverse effects of rich countries’ policies on poor countries; elimination of developed countries' policies will increase the world prices of agricultural commodities, which will benefit the farm-dependent developing countries.[11] Agarwal and Samanta analyse the interconnection between social achievement, structural adjustment, governance and economic performance; governance is measured by an index developed by the World Bank, and economic performance by growth of per capital income. Economic growth is not correlated with social progress, structural adjustment or governance; while the governance index is not correlated with growth of per capita income it is very highly correlated with social progress.[12]

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DOBRIŞAN ON RECENT TRENDS IN MONETARY POLICY

INTERNATIONAL LIQUIDITY AND MONETARY CONTROL

DORIN DOBRIŞAN

ABSTRACT. Mohanty and Scatigna contend that in a number of countries volatility in capital flows has been associated with speculative currency attacks, resulting in large changes in the exchange rate, high inflation and substantial loss of output. Andersen and Moreno remark that there is strong empirical evidence that external shocks are far more important in developing economies than in developing countries. Mihaljek says that standard monetary tools to deal with capital inflows may have to be supplemented by unconventional policy tools such as special privatization accounts and export earnings stabilization funds. Hawkins argues that the progressive easing of capital controls and the development of debt markets have undermined interest rate controls.

Mohanty and Scatigna contend that in a number of countries volatility in capital flows has been associated with speculative currency attacks, resulting in large changes in the exchange rate, high inflation and substantial loss of output; to the extent that wages and prices are rigid, a fall in external demand is expected to lead to a fall in both the nominal and real exchange rate, thus partially mitigating the impact of the adverse shock; when the exchange rate is fixed, prices must fall significantly to bring about the required real exchange rate and current account adjustments. "Authorities may intervene to limit exchange rate movements. However, unlike a fixed exchange rate, such interventions may not target a specific level of the exchange rate but may influence its path or volatility. The arguments for such smoothing tend to focus on special conditions facing emerging economies' financial markets. For example, the tradable sector's capacity to adjust to sudden changes in the exchange rate may be limited. As a result, volatile exchange rates can discourage exporters and importers from international trade."[1] Mohanty and Scatigna claim that emerging economies face a high degree of pass-through of exchange rate changes into inflation (this makes them particularly vulnerable to persistent exchange rate depreciations); prudential regulation of the financial system can be a partial solution to the mismatch problem (restricting the foreign currency open position of the banking sector can limit some of the adverse systemic implications of large current depreciations); an additional factor that might increase tolerance for exchange rate flexibility is the decline in the exchange rate pass-through to inflation in some countries. "Does responding to the exchange rate affect the main objectives of monetary policy, namely stabilizing inflation and output volatility? To the extent that the exchange rate has significant implications for domestic prices, reacting to currency volatility may not reduce the central bank's control over inflation. The recent success of emerging economies in reducing inflation to a low level might support such an argument. Inflation has been within the target or reference range in most countries during the past three years. This provides some evidence that countries which have contained exchange rate fluctuations have not compromised their inflation objectives in doing so. In contrast, many countries (Brazil, Indonesia, Russia, Turkey and Venezuela) that missed their inflation targets (or the threshold rates) happened to have experienced large currency depreciations."[2]

Andersen and Moreno remark that there is strong empirical evidence that external shocks are far more important in developing economies than in developing countries; central banks still tend to intervene or adjust domestic interest rates in response to exchange rate movements rather than use their independence to pursue domestic policy targets; the process of financial integration has been uneven and experienced partial reversals. "Market participants may have to unwind their positions involuntarily (due to triggers or prudential requirements) in ways that might increase volatility in other markets. At the same time, however, globalization may encourage the development of deeper foreign exchange markets, which may increase resilience to shocks."[3] Andersen and Moreno contend that foreign exchange market turnover increased considerably between 2001 and 2004, over 50% overall and even faster in a number of emerging market economies; the share of offshore transactions in many emerging market currencies has risen significantly; turnover in forward or swap transactions has increased relative to spot transactions in a number of emerging market currencies. "Turnover has not increased in all emerging market currencies. One explanation for this might be that central banks have significantly reduced their participation in forward markets as a result of losses incurred. The introduction of restrictions on forward currency markets or capital controls could also have played a role. For example, the measures adopted by the Malaysian authorities in September 1998 curtailed forward transactions in the ringgit. The Indonesian country paper describes measures designed to limit rupiah lending to non-residents, which would discourage taking speculative positions via forward markets (although forward or swap market rupiah transactions have nevertheless grown)."[4]

Mihaljek says that standard monetary tools to deal with capital inflows may have to be supplemented by unconventional policy tools such as special privatization accounts and export earnings stabilization funds; the expansionary effect of privatization-related inflows is largely the consequence of the so-called *stock-flow constraint* in emerging economies; the monetary consequences of volatile export earnings are equally pronounced. "For a country where shocks to the foreign exchange market and money supply represent several per cent of GDP a year and where inappropriate use of government funds may disrupt macroeconomic stability, there is a clear need for coordination of monetary and other macroeconomic policies. Even though the main role in managing privatization revenues and resource wealth belongs to fiscal policy, central banks need to take account of the profound implications of the management of these resources for monetary and exchange rate policy."[5] Mihaljek maintains that earmarking privatization receipts for specific uses, which could be potentially attractive from the political economy perspective, complicates fiscal management and makes it difficult to reallocate spending in response to changes in circumstances and priorities; stabilization funds provide no guarantee against the volatility of expenditure, as governments could still borrow in good times in order to finance additional spending; a case may exist for placing the assets of a stabilization fund abroad, since investment in domestic non-governmental financial assets could transmit resource volatility to the economy. "Government balances at the central bank were highly cyclical. In response, the government established an explicit oil stabilization fund. The fund, which began operations in 2004, accumulates resources when the price of Urals Crude exceeds $20 per barrel, while withdrawals are permitted when the price falls below this threshold. The total amount in the fund is capped. The fund's resources will be used for external debt repayment and (in case the price of oil stays below $20 per barrel for more than a year) stabilization of the government budget. The operation of the fund should help the central bank sharpen its focus on exchange rate policy, as supply and demand will play a greater role in the determination of the exchange rate in a more certain foreign exchange market environment."[6]

Hawkins argues that the progressive easing of capital controls and the development of debt markets have undermined interest rate controls; intermediation prevented from occurring through banks would take place through bank-like intermediaries such as building societies, savings and loan associations, finance companies and merchant banks; interest rate moves can be readily compared with market expectations embedded in the yield curve, which is not the case with a quantity target. "As medium-term interest rates reflect expectations of future movements in short-term rates, central banks have more influence over medium-term rates when short-term rates give a clear signal. More orderly market conditions may make the transmission mechanism quicker and more predictable. Moreover, it should assist in the quest for financial stability by making it easier for financial institutions to assess and manage risks. Excessive volatility in money markets may feed uncertainty about economic fundamentals. Failure to keep overnight rates near the announced target may adversely affect the overall reputation of the central bank, especially if interest volatility is seen as a symptom of misallocation of liquidity among banks and uncertainty about monetary policy. Furthermore, interest volatility blurs signals from the market."[7] Hawkins asserts that from early to mid-2002 international investor sentiment about Latin American economies deteriorated, as reflected in bond spreads and exchange rate depreciations; the central bank will most readily be able to use the bank reserves market to influence overall financial market conditions when this market operates smoothly; government securities markets are now reasonably liquid in most emerging economies, although often less so than in advanced economies. "In Chile, the central bank issued promissory notes in the 1990s to fund accumulation of international reserves associated with intervention intended to hold back the peso's appreciation. The resultant interest expenses are still causing losses. In some economies (e.g., the Philippines, Poland), the central bank ceased issuing its own securities for market operations. There are some plausible arguments against having both government and central bank paper on issue. Splitting the public sector paper market between government and central paper makes both less liquid. [...] As central banks increasingly use repos rather than outright transactions, liquidity in the repo market will become the more important factor."[8]

Moreno and Villar note that the past decade has seen a transformation of the role of foreign banks in emerging markets; a larger foreign bank presence can enhance the competitiveness of the banking sector; a more competitive and efficient banking system can improve the effectiveness of monetary policy transmission by tightening the link between policy rates and deposit/lending rates; foreign bank entry can help countries recapitalize their banking systems in the aftermath of banking crises, providing the basis for a revival of bank credit. “A foreign bank presence could be particularly valuable during periods of banking stress, to diversify against country-specific (systemic) risks that can severely impair the capital of the banking system. The fact that foreign banks are diversified across different countries could well change the cyclical behaviour of the host country financial system since foreign banks are less sensitive to host country cycles. How valuable this proves to be in practice depends on how closely the domestic economic cycle is correlated with the global economy. Counter cyclical changes in foreign bank lending could also help to amplify the effectiveness of monetary policy. Foreign banks could also be more resilient during currency crises. Not only do they tend to be more aware of currency mismatches, they can also call on their parent organizations to provide foreign currency liquidity.”[9]

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A MARKET-BASED SYSTEM OF MONETARY MANAGEMENT AND MONETARY POLICY OPERATING PROCEDURES

DORIN DOBRIŞAN

ABSTRACT. Hawkins claims that financial innovation and globalization have led most central banks to operate monetary policy by influencing conditions in the market for bank reserves. Moreno and Villar contend that foreign bank entry may enhance financial stability by permitting greater diversification of exposures and by improving risk management. Mihaljek says that if foreign exchange earnings from oil exports are converted into domestic currency and spent on non-tradables, this can lead to exchange rate appreciation and weaken a country's export competitiveness. Andersen and Moreno state that even with a systematic examination of the evidence, it is difficult to establish a robust relationship between financial integration and growth.

Hawkins claims that financial innovation and globalization have led most central banks to operate monetary policy by influencing conditions in the market for bank reserves; the central bank signals its monetary stance and supports this by structures or operations which keep the market-clearing interest rate close to the announced target; the responses of the authorities in the various economies differed, in part due to differences in their operating procedures but also in part because the shocks, transmission mechanisms and preferences of the authorities differed across the various economies. "Measures that may improve liquidity include governments issuing bonds even when running large surpluses; avoiding locking up a large proportion of government paper in mandatory holdings by banks and insurance companies to meet prudential requirements; shorter settlement cycles, which is facilitated by having 'dematerialised' securities; central counterparties and real-time gross settlement; better infrastructure for clearing and settlement; standardized conventions and master agreements; proper supervision of markets and participants; allowing short-selling; establishing benchmarks; developing associated derivatives markets; minimizing taxes on transactions; a liberal approach to participation by foreign banks in domestic financial markets."[1] According to Hawkins, central banks need to know about market expectations of short-term rates in order to assess the likely impact of a policy change; options are often thinly traded, particularly when their strike price is far away from the current future price and when they have a long maturity; banks almost always settle transactions between each other on the books of the central bank, for many reasons; banks are usually required to place a minimum amount of bank reserves with the central bank in proportion to their customers' deposits. "Foreign exchange intervention is generally not a major source of variability in the bank reserves market (other than during crises) in advanced economies. Given the standard two-day settlement lag for foreign exchange transactions, this component is known with certainty within the horizon of daily operations. However, emerging economies, even those eschewing formal pegs, more commonly engage in foreign exchange intervention, and sometimes in large amounts."[2]

Moreno and Villar contend that foreign bank entry may enhance financial stability by permitting greater diversification of exposures and by improving risk management; a number of empirical studies suggest foreign banks play a stabilizing role; the behaviour of foreign banks during certain episodes illustrates the potentially stabilizing role they can play; foreign bank entry might contribute to greater stability by increasing profits, and improving capital cushions, in the banking sector. "Foreign bank entry may lower risk through improved risk management techniques and more realistic provisioning against bad loans. As those techniques become more deeply rooted in the local banking culture (and perhaps as the quality of supervisory oversight improves), the stability of the local financial system should improve. [...] Policymakers in emerging economies have sought to enhance credit availability to small borrowers by seeking to reduce credit risk in two ways: (1) making information available to facilitate the assessment of the creditworthiness of borrowers in the economy, for example via the establishment of credit bureaus; (2) making it more costly for borrowers to fall behind in their payments, for example by improving the ability of lenders to attach assets."[3] Moreno and Villar claim that a large foreign banking presence could mean that information available to host country supervisors can be reduced to the extent that decision-making and risk management shifts to the parent bank; a large foreign bank presence can expose a country to shocks due to purely external events, such as those affecting the parent bank; another issue is the regulatory treatment of foreign currency denominated lending: a borrower that chooses dollar borrowing to cover local currency business makes itself a worse credit risk. “A development of great importance has been that lending by big local affiliates has progressively displaced direct dollar-denominated lending by the head offices of international banks. This is potentially a positive development as it can mean greater borrowing in local currency and thus smaller currency mismatches. In addition, the deeper local presence of international banks may contribute to greater efficiency and resilience of the financial sector. The greater scale and changing character of foreign participation in banking systems raise many questions: about the impact on the efficiency of financial institutions; about the macroeconomic effects on aggregate lending and on the responsiveness to monetary policy; and about the implications for financial sector stability.”[4]

Mihaljek says that if foreign exchange earnings from oil exports are converted into domestic currency and spent on nontradables, this can lead to exchange rate appreciation and weaken a country’s export competitiveness; the precise effects of privatization receipts depend on the uses of such receipts; the repayment of debt owed by the government to the central bank would have the same advantages for monetary policy as the repayment of external debt. "The main element was the establishment of a special privatization account in which the foreign exchange proceeds from the large sales of state property were to be deposited. Any conversion of the funds withdrawn from this account into domestic currency was done outside the foreign exchange market: the Czech National Bank would purchase the foreign exchange from the government at the prevailing market exchange rate and transfer the foreign exchange to its international reserves. Because the transaction was not intermediated in the domestic foreign exchange and money markets, it did not affect the exchange rate or the interest rate. The government spent most of the proceeds on housing and infrastructure development, which helped smooth the impact on aggregate demand."[5] Mihaljek argues that Chile's copper stabilization fund was established in 1985 following a sustained increase in the international copper price; Venezuela established a macroeconomic stabilization fund in 1998 with the objective of insulating the budget and the economy from fluctuations in oil prices; Mexico established a small oil stabilization fund in 2000 (the fund's rules envisage that a proportion of total federal government revenue in excess of budgeted amounts is to be deposited); Colombia has used an oil stabilization fund to smooth the flow of proceeds from oil exports; an oil stabilization fund in Algeria was established in 2000; high oil and gas revenues have translated into a particularly acute monetary dilemma in Russia. "Contingent stabilization funds are designed to accumulate resources when the export commodity price or revenue exceeds some threshold, and to pay out when the price or revenue falls below a second threshold. The thresholds are usually preannounced. By transferring uncertainty and volatility to the fund, recurrent resources available to the budget are made more predictable and stable. In a financing fund the operational rules are designed so that the fund effectively finances the overall budget balance. The fund accumulates assets to the extent that there are actual surpluses in government finances. A separate institutional structure for the management of the fund is not required because all revenues and expenditures can be managed in a special government account. Russia, for instance, has operated such a 'virtual fund' in recent years."[6]

Andersen and Moreno state that even with a systematic examination of the evidence, it is difficult to establish a robust relationship between financial integration and growth; there is little evidence that financial integration has helped to stabilize fluctuations in consumption relative to income; capital flows to emerging economies are volatile, including episodes of so-called "sudden stops" and closure of access to international bond markets. "In some cases, governments have encouraged financial market development by stepping up central bank issuance of its own securities. However, this has the disadvantage of potentially exposing the central bank balance sheet to interest rate risk and of fragmentary markets by increasing the types of securities on offer. On solution, adopted in India in early 2004, is to issue special government securities to be used by the central bank in managing domestic liquidity. Some countries have adopted legislation to strengthen risk management in the banking sector through improved regulation and liberalized foreign bank entry."[7] Andersen and Moreno contend that access to global markets can help reduce the fluctuations of consumption relative to income emanating from internal shocks; many countries have removed capital controls while attempting to maintain monetary policy independence by adopting a more flexible exchange rate regime; for countries that are still at an early stage of integration, volatility of consumption relative to income has actually increased. "Theory predicts that capital should flow from high-saving developed countries (where the marginal return to capital might be relatively low) to low-saving developing countries (where a high return to capital is expected) and thereby increase the global return to capital. Yet the reality has been totally different. Since 1997, the developed countries have been running a widening current account deficit, almost entirely due to developments in the United States. This deficit has been financed by current account surpluses in and capital outflows from emerging economies, notably Asia. In other words, there has been a net transfer of resources from developing to developed countries. One reason for this apparent paradox might be that returns in emerging market countries are still highly uncertain, notably where debt levels exceed even relatively low thresholds."[8]

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FISCAL DEFICIT, EXTERNAL BALANCE AND MONETARY GROWTH

DORIN DOBRIŞAN

ABSTRACT. Bhattacharya says that, among country-specific studies on monetary policy frameworks, a study on India would be important. Gerlach and Gerlach-Kristen write that even though monetary policy makers in both economies have enviable records in delivering on their objectives, macroeconomic outcomes have differed and have at times been adverse. Ito holds that the Japanese financial system was stabilized by the second capital injection to large banks at the end of March 1999. Mariano and Villanueva claims that the last 15 years have seen extensive use of monetary policy approaches that are rules-based, but with considerable judgments factored in.

Bhattacharya says that, among country-specific studies on monetary policy frameworks, a study on India would be important; the Indian experience might throw up some interesting insights on the role of the monetary framework because rather than a dramatic cutoff, the fall in inflation in India had been gradual; a juxtaposition of the Indian versions of transparency and accountability to other economies with diverse monetary policy frameworks may extract what aspects of them are essential for better economic performance. "Rather than predictability of money growth or coordination problems, the key to understanding the change in framework perhaps lies in the signaling aspect of policy. The RBI wanted to communicate a strong signal to the market that it was changing the way it would implement monetary policy. The signal was to prepare the market for a gradual move from quantity-based signals to price-based signals. In this context, it is interesting to note that the Reddy Committee Report proposed a set of broader monetary measures that were supposed to capture the effects of new financial innovations better. However, unlike the US case, no attempt was made to shift to alternative monetary measures as targets."[1] Bhattacharya argues that the model-based exercises to understand the transmission mechanism were severely constrained in India by the lack of comprehensive and timely information in some areas; the way RBI words its monetary policy objectives makes it difficult to judge its performance against a well defined benchmark; inflation in India has fallen gradually (the GDP growth rate has increased and volatilities in both variables have demonstrably declined under the MIA); although the precise contribution of monetary policy in reducing the rate of inflation is difficult to arrive at, monetary policy in India facilitated the process of raising competitiveness and efficiency. "In our endeavour to understand the role of monetary policy and monetary frameworks in the light of the Indian experience, it is observed that monetary policy in India so far had largely been discretionary. The discretionary policies, at least during the 1990s, were unavoidable due to the immense structural changes that were required to transform a command and control economy to a market-based one. However, consistent with international trends during the 1990s, the motivations that led to such discretionary practices in India had generally been explained to economic agents in detail. Despite crucial differences in a few areas, the monetary policy framework in India has assimilated many of the best international practices."[2]

Gerlach and Gerlach-Kristen write that even though monetary policy makers in both economies have enviable records in delivering on their objectives, macroeconomic outcomes have differed and have at times been adverse; it is not possible on the basis of their analysis to infer whether one policy regime is preferable to the other, since this depends on policy makers' objectives, which differ; the policy framework in Hong Kong is completely geared to ensuring stability of the nominal exchange rate against the USD, implying that there are no monetary policy responses to inflation. "The parameter estimates of the equations for the output gap are generally quite similar, except for that on the lagged output gap, which is larger in Singapore than in Hong Kong. These findings suggest that the short-run effects of movements in the real exchange rate, real interest rate and US real import demand are similar, while the long-run effects are much larger in Singapore. However, the full effect of a shock depends also on the persistence of inflation since movements in prices impact on real interest and real exchange rates and thus play a role in restoring macroeconomic equilibrium."[3] Gerlach and Gerlach-

Kristen argue that inflation in Singapore has been lower and less volatile, and inflation shocks have been less persistent than in Hong Kong; despite the different monetary policy frameworks, real economic behaviour has been similar in the two economies. "The purpose of the analysis has been to assess macroeconomic responses in Hong Kong and Singapore to economic shocks and to explore the potential role of choice of monetary policy strategy in conditioning these reactions. It should be re-emphasised that it is not possible to infer on the basis of these findings whether one policy was more successful than the other. Such a judgement would depend on the objectives of policy makers in the two economies. Given the focus on nominal exchange rate fixity in Hong Kong and on inflation control in Singapore, these preferences appear to have been different."[4]

Ito holds that the Japanese financial system was stabilized by the second capital injection to large banks at the end of March 1999; the increase of the target level for current account balances was decided as a monetary policy measure, in addition to any stabilizing effect on the financial market and institutions; in the usual setting of positive interest rates, an unsterilised intervention is more potent than a sterilized intervention since unsterilised intervention will lower the interest rate. Ito asserts that the dissenters's reasons for the proposal to lower the target amount had changed slightly by September 2005: (i) the zero interest rate had distorted the market mechanism and made market participants unaware of the possible risk of interest rate volatility; (ii) in order to maintain the high balance, it had become necessary to conduct market operations with relatively long maturities, implying that it would take time to lower the target amount before raising the interest rate, thereby reducing the timeliness and flexibility of the Bank's conduct of monetary policy; (iii) gradual reduction of the target amount was appropriate; (iv) maintaining the zero interest rate without excess liquidity was enough to support economic recovery; (v) financial institutions' precautionary demand for liquidity had become lower. Ito focuses on the period after 1998, when the Bank gained legal independence and the economy fell into deflation. "The transparency of monetary policy decision-making was greatly enhanced under the new regime supported by the new law. It was often said that real decision-making was done internally (internal executive meeting) and the MP Board was rubber-stamping the decision that was already made. Under the old regime, there was no disclosure of minutes or transcript. The Monetary Policy Board was revamped in the appointment criteria. In April 1998, the Bank under the new law started to announce the decision on the day of meeting and the Governor gives a press conference on the decision within a few days. Detailed minutes are publicly disclosed several weeks after the meeting, comparable to the Federal Reserve Board, and the meeting minutes in about a month and a half. It was decided that the transcript would be disclosed in later years."[5]

Mariano and Villanueva claims that the last 15 years have seen extensive use of monetary policy approaches that are rules-based, but with considerable judgments factored in. “A common misconception is that policy rules are applied mechanically. True, such rules are often expressed as algebraic expressions; as such, they can be subject to econometric evaluation. Nevertheless, policy rules are generally used as policy frameworks or guidelines and in practice are not followed mechanically. Discretion is exercised when examining data on prices, industrial output and other variables in order to forecast the current inflation rate and the real output gap (real GDP measured as deviation from potential GDP). Likewise, there are special circumstances when a temporary departure from the policy rules is warranted.”[6] Mariano and Villanueva hold that an inflation target embedded in a good policy rule means an average value for inflation over several years; expectations of future changes in the policy instrument affect financial markets and the rest of the economy; the inertial response of the exchange rate to the inflation and output gap can be captured by the inclusion of the lagged value of the exchange rate on the right-hand side of the policy reaction function. “Exchange rate stabilization posed some problems for the conduct of monetary policy under inflation targeting, given the extent of exchange rate volatility observed over the past few years and the need to guide inflation expectations in the face of such volatility. In the end, monetary authorities relied on both their judgment and on the information at hand."[7]

Camen notes that a major objective of the Vietnamese authorities in the coming five years it is to strengthen the integration of the Vietnamese economy into the world economy; internationalization will pose major challenges for financial sector policies, underlining the importance of further progress with financial sector policies, underlining the importance of further progress with financial sector reforms and reforms of monetary policy. "Since the late 1980s, the Vietnamese authorities have implemented comprehensive financial sector reforms whose principal components were the transition from a monobank system to a two-tier banking system, the establishment of joint stock banks (JSB) the restructuring of state-owned commercial banks (SOCBs), the liberalization of interest rates and the development of financial markets. Reforms, which started in the first half of the 1990s, have since then been implemented gradually. As a result of the reforms, the Vietnamese financial system has deepened as indicated by the increased monetization. The ratio of M2 to GDP, about 25% in the mid-1990s, has increased to above 70% today."[8] Camen claims that money markets and financial markets in general continue to be thin and segmented; while Vietnam officially has a managed floating exchange rate system, currently the exchange rate system functions like a fixed exchange rate system; Vietnamese authorities accepted not to impose restrictions on the making of payments and transfers for current international transactions, and not to engage in any discriminatory currency arrangements or multiple currency practice, except with IMF approval. "The goals of monetary policy in the SBV Law are very broadly defined and a primary objective is not clearly identified. The multiplicity of goals without established hierarchy raises the risk of conflicting objectives. While in the SBV Law a hierarchy of goals is not established, the actual economic policy in Vietnam suggests that economic growth has been the de facto primary goal of the government."[9]

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